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Summary of the economic survey of Europe, 1997

Executive summary

The economic situation improved significantly in much of the region of the Economic Commission for Europe (ECE) in 1997. In the Western market economies (Western Europe and North America), it was the best year for gross domestic product (GDP) growth – an average 3.3 per cent – since 1989. In the transition economies of Eastern Europe, the Baltic States and the Commonwealth of Independent States (CIS), it was the first time since 1989 that the average growth rate was positive (1.7 per cent), this being a reflection of continued steady growth in Eastern Europe and, finally, the apparent end to seven consecutive years of falling GDP in the Russian Federation.

The outlook for economic developments throughout the region in 1998 depends to a considerable extent on how serious the ramifications of the 1997 crisis in Asia are likely to be. Most forecasts for the world economy have been lowered since last December and these imply a reduction of between ½ and ¾ of a percentage point in the forecasts made last autumn for Western Europe and North America: the *Economic Survey of Europe, 1998*, No. 1, however, stresses two points: first, that the Asian crisis is complex in that it is likely to affect a large number of variables not all of which are easy to estimate or include in the standard forecasting models; and, second, that actual developments will also depend on the monetary and fiscal policies adopted in the major market economies.

The current national forecasts point to no change in the average annual rate of GDP growth in Western Europe, that is to say, it is expected to remain at about 2.7 per cent. In the slow-growing countries of the last few years (France, Germany and Italy), GDP should pick up gradually (to some 2.5 to 2.8 per cent) but this will be offset by slower growth in the United Kingdom of Great Britain and Northern Ireland and in many of the smaller European economies.

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In the United States of America, domestic demand is still likely to remain quite strong in 1998, but the effective exchange-rate appreciation of the dollar and the spillover effects from Asia are likely to produce a significant fall in net exports. In short, GDP growth is expected to slow to about 2.5 per cent, from 3.8 per cent in 1997. This would imply an average growth rate of just over 2.5 per cent for the ECE market economies as a whole.

The direct effects of the Asian crisis on the transition economies are likely to be small. The main effect of any global shocks on Eastern Europe will be felt through their impact on Western European import demand. There could also be important effects on the supply of net capital inflows and the cost of financing.

In aggregate, Eastern European GDP is expected to grow by about 4½ per cent in 1998. This improvement on the 1997 performance would be largely due to a return to growth in Albania and Bulgaria and an end to decline in Romania. High rates of growth (5 to 7 per cent) are also expected in the Baltic States. An important problem facing many Eastern European economies in 1998 is how to handle their large current account deficits (many of these are 6 per cent or more of GDP and the figures are even higher in the Baltic States).

Among the major uncertainties identified as facing the ECE economies in 1998 are whether the Asian crisis will have much larger negative effects on real activity than are currently allowed for; and whether the introduction of the Eurodollar (Euro) will entail tighter fiscal policies in Western Europe. On both counts, the *Survey* takes the view that the downside risks are not negligible. Finally, there is a discussion of the risk of possible lowering of growth rates in the transition economies through exposure to increasingly volatile international capital flows.

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[1] The region of the Economic Commission for Europe (ECE) comprises the member countries of ECE, namely, the whole of Europe (East and West, including the Baltic States), the Commonwealth of Independent States (CIS), North America and Israel.

[2] United Nations publication, Sales No. E.98.II.E.1.

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Overview of the economic situation and selected issues in the region of the Economic Commission for Europe (ECE)

A. Economic developments in 1997

1. The economic situation improved significantly in much of the region of the Economic Commission for Europe (ECE)[1] in 1997. In the Western market economies (Western Europe and North America), it was the best year for gross domestic product (GDP) growth — an average 3.3 per cent — since 1989 (see table 1). In the transition economies of Eastern Europe, the Baltic States and the Commonwealth of Independent States (CIS), it was the first time since 1989 that the average growth rate was positive (1.7 per cent), this being a reflection of continued steady growth in Eastern Europe and, finally, the apparent end to seven consecutive years of falling GDP in the Russian Federation.

2. The relatively high growth rate of the Western economies was heavily influenced by the unexpected strength of the economy of the United States of America where buoyant domestic demand was responsible for an increase in GDP of 3.8 per cent, the largest rise since 1988. Household expenditures increased strongly (3.3 per cent), but so did fixed investment, which rose nearly 6.5 per cent (table 2). Business spending on computers and information technology was particularly strong (up 20 per cent) and since 1991 had increased in volume by 161 per cent. Despite the perennial fears that the introduction of new technology destroys jobs, total employment since 1991 had risen 13 per cent and in 1997 the average unemployment rate was 4.9 per cent, the lowest it had been since 1973. Although technical change, just like increased imports from developing countries, may create local problems of adjustment for individual groups of workers — and if they are unable to acquire new skills their relative income position may deteriorate — it is unlikely to be a major cause of unemployment in a growing economy. An important lesson to draw from the United States experience is that faster economic growth and a high rate of investment are very effective in reducing unemployment and coping with technological and structural change. Moreover, this combination — which, instead of being a new economic paradigm, reflects the rediscovery of the Keynesian insight of the 1950s and 1960s that full employment is possible with low inflation — sets up a virtuous circle of increased employment, higher productivity and low inflationary pressures. Fixed investment in the United States in 1997 raised the productive capacity of the manufacturing industry by more than 5 per cent and, despite the rapid growth of the last six years, capacity utilization rates are still several points below their peak in 1989. Productivity in manufacturing rose by nearly 4.1/2 per cent in 1997 and easily absorbed the rise in wages, with unit labour costs actually falling. The greater part of new jobs in the United States have been created in the services sector, in particular in business services which have also had high rates of investment in new technology.

3. In Western Europe, the growth of GDP averaged 2.7 per cent in 1997, a clear improvement on the 2 per cent increase in 1996. There was a steady, but by no means dramatic, improvement in domestic demand during the year and this tends to have a multiplier effect through the European economies because of their very close trading links. Nevertheless, Western European growth was still largely driven by exports and especially by the import demands of North America, the transition economies of Eastern Europe and CIS, and developing countries outside East Asia. Fixed investment picked up a little in 1997 (it rose by nearly 2.1/2 per cent against 1.6 per cent in 1996) but it was very weak in France, Germany and Italy; and even in the United Kingdom of Great Britain and Northern Ireland, where growth has been relatively strong for the last four years and profits relatively high, the increases were not very large. The investment that has taken place has tended to be in machinery and equipment rather than new buildings, and focused on the rationalization of production rather than the expansion of new capacities that would lead to higher employment.

4. Just as the contrast is frequently drawn between the dynamism of the United States economy and the slow growth of that of Western Europe, so within Europe a comparison is often made between the United Kingdom's buoyant economy and the continent's sluggish one. However, this is misleading since many of the smaller economies have in fact been growing rapidly since 1993, often at rates above that in the United Kingdom. Fixed investment in most of these smaller European economies has risen strongly, including business investment in new buildings; unemployment rates have been falling; and new jobs have been created at rates comparable with, or above, those in the United States and the United Kingdom. Within this sample of smaller economies, the variations in the institutional context of economic activity, particularly as regards the degree of labour-market regulation, are considerable and, given their economic performance, must raise serious doubts about the simplistic characterization of continental European labour markets as rigid and inflexible

Table 1
Growth of real GDP in the ECE market economies, 1995-1998
(Percentage change over previous year)

	1995	1996	1997[a]	1998[b]
Western Europe	2.7	2.0	2.7	2.7
European Union	2.5	1.7	2.6	2.7
Four major countries	2.3	1.4	2.4	2.5
France	2.1	1.5	2.4	2.8
Germany	1.8	1.4	2.2	2.5
Italy	2.9	0.7	1.5	2.5
United Kingdom	2.7	2.3	3.5	2.0
Seventeen smaller countries	3.3	3.0	3.5	3.2
Austria	2.1	1.6	2.0	2.5
Belgium	2.1	1.5	2.1	2.5
Cyprus	5.5	1.9	2.4	4.0
Denmark	2.6	2.7	3.0	2.7
Finland	5.1	3.6	5.9	3.5
Greece	1.8	2.6	3.4	3.0
Iceland	1.2	5.2	4.9	3.9
Ireland	10.4	7.7	8.5	6.5
Israel	6.4	4.5	2.1	2.5
Luxembourg	3.7	3.0	3.6	3.7
Malta	7.3	4.2	2.8	..
Netherlands	2.3	3.3	3.2	3.2
Norway	4.1	5.3	3.5	4.0
Portugal	1.9	3.0	3.4	3.5
Spain	2.7	2.3	3.4	3.5
Sweden	3.9	1.3	1.9	2.5
Switzerland	0.8	-0.2	0.7	1.5
Turkey	7.2	7.0	6.3	4.0
North America	2.0	2.6	3.8	2.6
Canada	2.2	1.2	3.8	3.2
United States	2.0	2.8	3.8	2.5
Total	2.3	2.3	3.3	2.6
Memorandum item:				
Japan	1.5	3.9	0.9	0.1
Total, including Japan	2.2	2.6	2.9	2.2

Sources: National statistics and national economic reports; OECD *Economic Outlook* (Paris), December 1997.

Note: All aggregates excluding Israel. Two dots (..) indicate data are not available.

[a] Preliminary estimates.

[b] Forecasts.

in contrast with the superior job-creating flexibility of labour markets in the United Kingdom and North America.[2] The European countries where unemployment has fallen most since 1993 tend to be those where, as is the case for the United States, economic growth and fixed investment have been strongest.

5. A general feature of developments in the Western market economies in 1997 was the persistence of very low rates of inflation and the absence of any serious incipient labour or other cost pressures. In Western Europe, the increase in consumer prices averaged less than 2 per cent in 1997, and despite a long period of sustained output growth it was also under 2 per cent in the United States towards the end of the year. There are many factors that have been suggested to explain this outcome, including labour-market deregulation, the declining influence of trade unions, increased competition in more open and interdependent economies, and widespread fears of unemployment, especially in Europe, where in the 1990s priority has been given to fiscal consolidation over growth and employment. Nevertheless, the experience of the United States and many of the smaller economies of Western Europe also suggest that growth, investment and rising productivity are playing an important role in sustaining low inflation and increased employment. More generally, the aftershocks of the inflationary crisis of the 1970s now seem to have worked themselves out of the system, and this has been accompanied by a decline of inflationary expectations to levels prevailing before the 1970s. Inflationary pressures will obviously tend to continue to emerge but these are more likely to reflect normal fluctuations in the business cycle and as such are easily reversible. A more worrying concern has been raised in a general way by the Chairman of the Board of the Federal Reserve System of the United States, namely that at very low rates of inflation there is an increased risk, because of upward biases in the available measures of consumer price inflation, of an economy's possibly being tipped into deflation owing to a too hasty tightening of monetary policy.[3]

6. In Eastern Europe and the Baltic States, 1997 was generally a year of relatively high rates of growth. The average rate of growth for Central and Eastern Europe (2.8 per cent) was actually much lower than in 1996 (4.1 per cent), but this was largely due to the large falls in GDP in Albania, Bulgaria and Romania, and a sharp deceleration of growth in the Czech Republic (see table 3). In these countries, policy makers have been grappling with the consequences of severe financial crises in 1996 and 1997, which in turn were the result of the existence of poor macroeconomic fundamentals, and weak reform

Table 2

Major components of demand in the ECE market economies, 1996-1997

(Percentage change over preceding year)

	Private consumption		*Government consumption*		*Gross fixed investment*		*Stock-building*		*Total domestic demand*		*Exports*		*Imports*		*Net exports*[a]	
	1996	*1997*	*1996*	*1997*	*1996*	*1997*	*1996*	*1997*	*1996*	*1997*	*1996*	*1997*	*1996*	*1997*	*1996*	*1997*
Western Europe	2.4	2.1	1.9	0.9	1.6	2.4	-0.4	0.4	1.7	2.3	5.5	9.0	4.3	8.1	0.3	0.4
European Union	2.0	2.0	1.5	0.7	1.1	2.1	-0.3	0.4	1.4	2.2	4.8	8.7	3.7	7.8	0.3	0.4
Four major countries	2.0	1.7	1.8	0.6	—	0.8	-0.3	0.6	1.2	1.9	4.1	8.6	3.0	7.7	0.3	0.4
France	2.1	0.9	1.7	1.6	-0.5	0.2	-0.5	0.1	1.0	1.0	4.8	11.3	2.8	6.6	0.6	1.4
Germany	1.4	0.2	2.6	-0.4	-1.2	0.2	-0.3	1.1	0.8	1.2	5.1	10.7	2.8	7.0	0.6	1.0
Italy	1.1	2.3	0.5	-0.7	0.4	0.6	-0.3	1.0	0.5	2.5	-0.6	6.5	-1.7	11.9	0.2	-0.9
United Kingdom	3.6	4.2	2.0	2.3	1.8	2.7	-0.2	-0.1	2.7	3.5	6.8	4.9	8.4	5.6	-0.5	-0.3
Seventeen smaller countries	3.2	3.0	2.0	1.4	4.9	5.6	-0.6	-0.1	2.7	3.1	8.3	9.8	7.0	8.8	0.3	0.3
Austria	2.4	0.5	0.1	0.8	2.4	2.8	-0.6	0.1	1.4	1.2	9.3	6.5	8.7	4.8	0.2	0.8
Belgium	1.3	1.0	1.8	0.7	0.6	3.8	-0.1	0.2	1.1	1.7	3.2	4.9	2.8	4.5	0.4	0.5
Cyprus	2.5	-1.1	11.9	7.1	2.2	-5.2	-0.5	-0.2	3.2	-0.7	3.5	0.2	5.6	-4.5	-1.4	2.6
Denmark	2.6	4.0	2.4	2.0	7.5	7.2	-0.7	0.6	2.6	4.7	2.3	4.5	2.1	8.6	0.2	-1.4
Finland	3.8	3.1	3.5	-0.3	8.4	11.3	-0.7	0.3	3.7	4.3	3.9	13.5	4.3	9.3	0.2	2.1
Greece	2.3	2.3	0.5	2.5	9.4	11.7	1.0	1.2	3.8	4.7	0.2	3.7	3.9	6.7	-1.8	-2.0
Iceland	6.4	5.2	1.4	2.2	23.5	19.8	-0.7	—	7.1	7.1	10.0	4.0	16.6	10.3	-1.6	-2.0
Ireland	6.3	6.5	2.9	2.5	15.9	13.5	0.8	-0.1	8.4	7.1	10.0	13.0	11.4	12.3	0.6	2.5
Israel	5.2	3.3	5.5	1.8	6.8	-6.7	0.4	0.5	6.0	1.2	5.0	7.5	8.4	3.4	-2.5	0.7
Luxembourg	1.9	2.8	3.3	3.9	-1.7	8.0	0.6	-0.2	1.8	4.0	2.3	4.6	1.0	5.2	1.5	0.1
Malta	6.0	2.8	8.0	0.1	-4.9	-5.5	0.8	-4.0	4.6	-3.7	-5.0	3.7	-4.9	-6.1	-0.2	6.4
Netherlands	3.0	3.1	1.2	2.1	6.1	6.1	—	-0.3	3.4	3.3	4.5	5.8	5.3	6.3	-0.1	0.2
Norway	4.7	3.0	3.3	2.5	4.8	15.1	-0.5	0.6	3.7	6.2	10.0	4.1	6.5	11.9	1.9	-2.2
Portugal	2.2	2.6	1.6	1.8	7.7	9.0	-0.1	—	3.4	4.1	7.7	8.3	7.5	8.7	-0.8	-1.2
Spain	1.9	3.1	0.1	0.7	0.9	4.7	-0.1	-0.4	1.4	2.7	9.9	12.9	6.2	10.1	0.9	0.7
Sweden	1.3	2.0	-0.2	-2.4	3.7	-0.6	-1.1	0.5	0.1	0.9	6.1	10.9	3.7	10.1	1.2	1.2
Switzerland	0.7	0.9	0.7	-0.3	-2.7	-1.5	-0.1	-0.1	-0.2	0.1	2.5	8.2	2.4	6.7	—	0.6
Turkey	9.3	6.0	8.6	4.7	13.5	6.6	-3.1	-0.7	7.2	5.4	21.7	17.5	19.0	13.4	-0.2	0.5
North America	2.6	3.3	-0.1	1.1	7.2	6.8	-0.1	0.6	2.8	4.2	8.1	12.1	8.8	14.2	-0.2	-0.5
Canada	2.4	3.9	-1.3	-0.1	4.8	11.4	-0.9	0.7	1.1	5.1	5.7	8.6	5.2	13.4	0.3	-1.4
United States	2.6	3.3	—	1.2	7.4	6.4	—	0.6	3.0	4.1	8.3	12.4	9.1	14.3	-0.2	-0.5
Total	2.5	2.7	0.9	1.0	4.4	4.6	-0.3	0.5	2.2	3.2	6.8	10.6	6.6	11.1	—	-0.1
Memorandum item:																
Japan	2.9	1.4	1.5	0.8	9.5	-4.2	0.1	-0.1	4.8	-0.5	3.5	10.9	11.5	-0.1	-0.8	1.4
Total, including Japan	2.5	2.5	1.0	1.0	5.2	3.2	-0.2	0.4	2.6	2.7	6.3	10.6	7.4	9.4	—	0.1

Sources: National statistics and OECD *Economic Outlook* (Paris), December 1997.

Note: All aggregates excluding Israel. A dash (—) indicates that the amount is nil or negligible.

[a] Percentage point contribution to annual GDP growth.

Table 3

Basic economic indicators for the ECE transition economies, 1995-1998

(Rates of change and shares: percentage)

	GDP (growth rate)					*Industrial output (growth rate)*			*Inflation (percentage change, December-December)*			*Unemployment rate (end of period, percentage)*		
			1997											
	1995	*1996*	*Ex ante forecast*	*Actual outcome*	*1998 forecast*	*1995*	*1996*	*1997*	*1995*	*1996*	*1997*	*1995*	*1996*	*1997*
Eastern Europe	5.9	4.1	3½	2.8	4½	8.0	5.8	5.7	..	..	..	12.5	11.8	11.6
Albania	8.0	9.1	..	-7*	12	-7.2	13.6	-5.6	6.0	17.4	42.0	13.1	12.1	13.4[a]
Bosnia and Herzegovina[b]	..	..	..	..	..	60.8	87.3	35.1	-34.2	3.2	12.2	..	..	..
Bulgaria	2.1	-10.9	-(2-4)	-7.4	3	9.1	-8.3	-7*	33.0	311.1	578.7	11.1	12.5	13.7
Croatia	7.1	6.0	5.5	6.5	5	0.3	3.1	6.8	3.7	3.5	4.0	17.6	15.9	17.6
Czech Republic	5.9	4.1	4-5	1.3	1.6-2.2	8.7	1.8	2.3	7.9	8.7	9.9	2.9	3.5	5.2
Hungary	1.5	1.3	2	4.0	4	4.5	3.4	11.1	28.5	20.0	18.4	10.4	10.5	10.4
Poland	7.0	6.1	5-6	6.9	5.6-5.8	9.7	8.3	11.3	22.0	18.7	13.2	14.9	13.2	10.5
Romania	7.1	4.1	-2	-6.6	—	9.4	9.9	-5.9	27.7	56.8	151.7	9.5	6.3	8.8
Slovakia	7.3	6.9	6	6.5	5	8.3	2.4	2.7	7.4	5.5	6.5	13.1	12.8	12.5
Slovenia	4.1	3.1	4	3.3	3.5-4	2.0	1.0	1.3	8.6	8.8	9.5	14.5	14.4	14.8
The former Yugoslav Republic of Macedonia	-1.2	0.7	..	..	5	-10.8	3.1	1[c]	11.2	0.3	4.5	37.2	39.8	42.4[c]
Yugoslavia[d]	6.1	5.9	13	7.4	10	3.8	7.5	9.5	110.7	59.9	10.3	24.7	26.1	25.6
Baltic States	2.1	3.7	4½	6.5	6	1.3	4.6	5.8	..	..	..	6.5	6.4	6.3
Estonia	4.3	4.0	4-5	9	5.5-6	1.9	2.9	13.4	28.8	14.9	12.3	5.0	5.6	4.6
Latvia	-0.8	2.8	3.5	6.0	5-6	-3.7	5.5	6.1	23.3	13.2	7.0	6.6	7.2	6.7
Lithuania	3.0	4.2	5	5.0	7	5.3	5.0	0.7	35.5	13.1	8.5	7.3	6.2	6.7
CIS	-5.5	-4.4	..	0.7	..	-5.9	-2.8	2.3	..	..	..	5.8	6.2	6.2
Armenia	6.9	5.8	..	3.0	5-6	1.5	1.2	1.0	32.0	5.6	21.8	8.1	9.7	11.0
Azerbaijan	-11.8	1.3	..	5.8	..	-17.2	-6.7	0.3	84.5	6.8	0.3	1.1	1.1	1.3
Belarus	-10.4	2.8	5	10.4	7-8	-11.7	3.5	17.6	244.2	39.1	63.4	2.7	4.0	2.8
Georgia	2.6	8.6	..	11.3	11-13	-9.8	7.7	8.1	57.4	13.6	7.3	3.4	3.2	2.6
Kazakhstan	-8.2	0.5	2	2.0	3.5	-8.2	0.3	4.0	60.4	28.6	11.3	2.1	4.1	3.9
Kyrgyzstan	-5.4	7.1	..	10.4	7	-17.8	8.8	46.8	31.9	35.0	14.7	3.0	4.5	3.1
Republic of Moldova[e]	-1.9	-7.8	5-7	1.3	..	-3.9	-6.5	-2.3	23.8	15.1	11.1	1.4	1.5	1.7
Russian Federation	-4.1	-4.9	0-2	0.4	1.2-2	-3.3	-4.0	1.9	131.4	21.8	11.0	8.9	9.3	9.0
Tajikistan	-12.4	-16.7	..	1.7	..	-13.6	-23.9	-2.5	2 382.2	40.6	159.9	1.8	2.4	2.8
Turkmenistan	-7.7	0.1	..	-20*	..	-6.4	17.9	-35*	..	..	..	..	..	..
Ukraine	-12.2	-10.0	—	-3.0	0.5	-12.0	-5.1	-1.8	181.7	39.7	10.1	0.6	1.5	2.8
Uzbekistan	-0.9	1.7	..	5.2	6	0.1	6.0	6.5	..	..	..	0.3	0.3	0.3
Total	**-1.3**	**-1.0**	..	**1.7**	..	**-1.6**	**0.2**	**3.6**	..	..	..	**7.5**	**7.8**	**7.7**
Memorandum items														
CETE-5	5.9	5.1	4½	5.4	5	8.5	6.1	8.9	..	..	..	12.0	11.3	9.9
SETE-7	5.9	2.1	..	-3.0	3	6.7	5.1	-2.5	..	..	..	13.7	12.5	14.2
Länder ex-GDR[f]	5.2	1.9	1.0	1.6	2	5.8	4.6	6.7	2.6	1.6	2.3	14.9	15.9	19.4

Sources: National statistics, Commonwealth of Independent States (CIS) Statistical Committee and direct communications from national statistical offices to the Economic Commission for Europe (ECE) secretariat (International Monetary Fund and World Bank data for Albania).

Note: Aggregates are ECE secretariat computations, based on previous period weights at 1992 prices. Output measures are in real terms (constant prices). Forecasts are those of national conjunctural institutes or governmental forecasts associated with the central budget formulation. Industrial output refers to gross output, not the contribution of industry to GDP. Inflation refers to changes in the consumer price index. Unemployment generally refers to registered unemployment at the end of the period (with the exception of the Russian Federation where it is the Goskomstat estimate according to the International Labour Organization definition and Estonia where it refers to job-seekers). Aggregates shown are Eastern Europe (the 12 countries below that line), with sub-aggregates CETE-5 (central European transition economies: Czech Republic, Hungary, Poland, Slovakia, Slovenia) and SETE-7 (south European transition economies: Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Romania, the former Yugoslav Republic of Macedonia and Yugoslavia), Baltic States (Estonia, Latvia, Lithuania), CIS (12 member countries of CIS, and total transition countries.

Two dots (..) indicate data are not available; a dash (—) indicates that the amount is nil or negligible; an asterisk (*) after a numeral indicates an ECE secretariat estimate.

[a] June.

[b] Data reported by the Statistical Office of the federation; these exclude the area of Republika Srpska.

[c] November.

[d] Gross material product instead of GDP.

[e] Excluding Transnistria.

[f] States of the former German Democratic Republic.

programmes, especially as regards the banking and enterprise sectors. At the root of most of these setbacks is the lack of a political and social consensus on a radical transformation programme. Considerable progress has been made towards establishing macroeconomic stability in Bulgaria, especially since the creation of a currency board in July 1997, but a long process of structural adjustment still lies ahead. The increasing divergence in terms of economic reform and development between these south-east European countries together with Bosnia and Herzegovina and Yugoslavia and those in Central Europe and the Baltic States is a matter of growing concern – not only because of the heavy costs to the people of south-east Europe but also because of the risks to economic and political stability in the region as a whole.

7. Apart from the setback to the Czech economy in 1997,[4] growth rates were generally higher than expected at the start of the year and in several countries (Croatia, Poland and Slovakia) GDP increased by 6 per cent or more. A strong recovery now appears to be well established in the Baltic States where growth in 1997 ranged between 5 per cent in Lithuania and 9 per cent in Estonia.

8. A major feature of the recovery in Central Europe is the rapid growth of the industrial sector. Industrial output in Hungary and Poland grew more than 11 per cent in 1997 and by some 7 per cent in Croatia; in Latvia it was more than 6 per cent and in Estonia over 13 per cent. Industry also seems to be attracting a large share of the expansion in fixed investment: investment in industry has grown strongly in recent years in Croatia, the Czech Republic, Poland, Romania, Slovakia and Slovenia; in Poland, for example, about half of all private sector investment last year was in the manufacturing industry. Some of the effects of this new investment are beginning to appear in the changing structure and improved competitiveness of exports of manufactured goods.[5] Contrary to earlier expectations that the services sector would be the principal source of new jobs as the general restructuring process got under way, industry appears to be the main generator of private sector employment. New jobs in services are not negligible but only in the Czech Republic are services the major source of the jobs.[6] Thus, far from developing a post-industrial economy dominated by services, most of the Eastern European transition economies seem to be embarking on a process of reindustrialization with a strong export orientation.

9. Despite high rates of economic growth, there was only a marginal rise in the total level of employment in Eastern Europe in 1997, and this was largely due to Poland where output has been growing strongly for five years. Unemployment rates remain high – an average of 11.6 per cent in Eastern Europe at the end of 1997, 6.3 per cent in the Baltic States – and, again, only in Poland has there been a significant improvement (as reflected by a decline in the unemployment rate from 13.2 to 10.5 per cent between December 1996 and December 1997). Given the depth of the transition recession in Eastern Europe and the scale of the restructuring under way, it is not very surprising that employment is slow to respond to the recovery in output. In Poland, employment continued to fall for at least two years after the recovery in output had started. This underlines the importance of sustaining the highest feasible growth rates over a number of years.

10. In spite of serious setbacks in some of the south-east European economies, inflation rates have fallen markedly in most of the transition economies in the last few years, although progress was less marked in Eastern Europe in 1997. Leaving aside Albania, Bulgaria and Romania, the average increase in consumer prices in Eastern Europe and the Baltic States in 1997 ranged from 4 per cent in Croatia to over 18 per cent in Hungary. The rate of increase in wages has continued to fall and widespread improvements in productivity, largely associated with increased output, have considerably lowered the growth in unit labour costs. An important feature of measured inflation rates in Eastern Europe and the Baltic States is that they still contain a significant component of relative price adjustments. Despite the rapid liberalization of prices of goods, the prices of many services (rents, utilities, public transport and so on) as well as energy prices are being only gradually increased to market levels so as to avert social hardship and unrest. This gradual decontrol of administered prices helps to explain the persistent high growth of service prices in most of the transition economies which in turn contributes to the persistence of moderately high rates of overall "inflation". Clearly, it is important to bear in mind this relative price effect when assessing progress towards macroeconomic stability in the above-mentioned economies. The relatively lower inflation rate in one or two countries rather than signal the success of a stabilization policy, reflects a reluctance to make the necessary adjustments to administered prices with its promise of greater problems in the future.

11. As regards CIS, the most significant macroeconomic development in 1997 was the apparent end of seven years of falling output in the Russian Federation. The increase in GDP was marginal and the prospects for continued recovery are uncertain, but there are nevertheless signs of improvement in various parts of the economy. The main source of growth was in the manufacturing industry with a recovery taking place in a number of sectors. There was also

a revival of consumer demand for the first time since 1990 and Russian manufacturers appear to be starting to regain shares in their domestic market. One of the major achievements in the Russian economy has been the reduction in the inflation rate from an annualized quarterly rate of 400 per cent in early 1995 to 2.8 per cent in the last quarter of 1997.

12. Output was also growing in all the other CIS countries in 1997 except Turkmenistan and Ukraine, and there was also a significant fall in inflation rates in most of them. Tight monetary policies and stable exchange rates were largely responsible for the latter, although higher productivity, and increased price stability in the Russian Federation, the principal trading partner of the other CIS countries, also had an influence.

B. Outlook for 1998

13. The outlook for economic development throughout the region in 1998 depends to a considerable extent on how serious the ramifications of the 1997 crisis in Asia are likely to be.[7] Most forecasts for the world economy have been lowered since last December and these imply a reduction of between ½ and ¾ of a percentage point in the forecasts made last autumn for Western Europe and North America. However, it is important to stress two points: first, that the Asian crisis is complex in that it is likely to affect a large number of variables not all of which are easy to estimate or included in the standard forecasting models; and, second, that actual developments will also depend on the monetary and fiscal policies adopted in the major market economies.

14. Among the principal factors behind the improvement in the growth performance of the market economies in the last few years have been falling rates of inflation and lower interest rates. These developments are likely to continue: inflation rates and expectations are remarkably low, and the policy commitment to price stability has if anything increased in the run-up to Economic and Monetary Union (EMU); and expectations of further increases in interest rates have weakened since the beginning of the year. If maintained, such developments would help to maintain domestic demand and in Europe they should continue to partly offset the deflationary impact of the fiscal consolidation required by the Maastricht criteria.

15. The current national forecasts point to no change in the average annual rate of GDP growth in Western Europe, that is to say, it is expected to remain at about 2.7 per cent. In the slow-growing countries of the last few years (France, Germany and Italy) GDP should pick up gradually (to some 2.5 to 2.8 per cent) but this will be offset by slower growth in the United Kingdom and in many of the smaller European economies.

16. In the United States, domestic demand is still likely to remain quite strong in 1998, but the effective exchange-rate appreciation of the dollar and the spillover effects from Asia are likely to produce a significant fall in net exports. (It is this latter deterioration that is seen by the United States monetary authorities as an alternative to the rise in interest rates which would otherwise have been considered appropriate.) In short, GDP growth is expected to slow to about 2.5 per cent, from 3.8 per cent in 1997; this would imply an average growth rate of just over 2.5 per cent for the ECE market economies as a whole.

17. The direct effects of the Asian crisis on the transition economies are likely to be small. The East Asian markets take only about 2 per cent of the total exports of Eastern Europe and the proportion is even less for the Baltic States. The Russian Federation has important links with China, but not with the other Asian economies. The transition economies could face greater competition from Asian exporters in their principal markets; however, although this possibility cannot be dismissed, Asian exports do not appear in general to be close substitutes for those from Eastern Europe and the Baltic States. The main effect of any global shocks on Eastern Europe will thus be felt through their impact on Western European import demand. There could also be important effects on the supply of net capital inflows and the cost of finance; these are difficult to anticipate, although, to date, there does not appear to have been any serious impact. However, a number of loan and bond issues by entities in the transition economies have in fact been postponed, and the spreads or risk premiums demanded by foreign investors are still higher than they were before October 1997.[8] Domestic interest rates are also higher in most countries and in the Russian Federation and Ukraine, at least, this is almost entirely due to the effects of the Asian crisis.

18. In aggregate, Eastern European GDP is expected to grow by about 4 ½ per cent in 1998. This improvement on the 1997 performance would largely be due to a return to growth in Albania and Bulgaria and an end to decline in Romania. In the faster-growing economies of 1997 (Croatia, Poland and Slovakia), there will be some deceleration as policies are tightened to check the growth of current account deficits. Even so, these three economies are still expected to grow by 5 per cent or more. High rates of growth (5 to 7 per cent) are also expected in the Baltic States, despite some slowing down in Estonia to avoid overheating. An important problem facing many Eastern European economies in 1998

is how to handle their large current account deficits (many of these are 6 per cent or more of GDP and the figures are even higher in the Baltic States) (see table 4), especially in the more uncertain climate prevailing after the Asian crisis and, more generally, in the light of the difficulties created by the volatility of international capital flows (see below).

19. The Russian economy is also vulnerable to fluctuations on international capital markets and to the behaviour of foreign investors, since a large share of the Government's budget deficit is currently financed by foreign portfolio funds. Within Russian official circles, there is at present a wide range of forecasts for the current year but these are often little more than working assumptions or guesstimates. It is difficult to see a significant strengthening of the recovery in the Russian Federation if monetary policy remains as tight as it is at present for any length of time. Moreover an important constraint on medium-term growth in the Russian Federation is the effect of a large 10-year decline in fixed investment on productive capacities. There was in fact a first, small increase of investment in the last quarter of 1997, but whether this fragile beginning will lead to a sustained recovery remains to be seen.

C. Uncertainties

20. One of the major uncertainties facing the world and ECE economies in 1998 is whether the Asian crisis will have much larger negative effects on real activity than are currently allowed for.[9]

21. The generally optimistic view, as outlined above, tends to emphasize the relatively low trade dependence on South-East Asia of most of the Western market economies. This view ignores, however, a number of other issues. The first concerns the fact that there are many items in the external accounts other than merchandise trade that will be affected by the crisis. Many Western companies derive large profits from Asia without exporting there, as do many banks from their investments in the area, many of which are now at risk. In addition there are a large number of services that will be affected. The net impact on all these flows of income and capital is uncertain, partly because the relevant data are not readily available and partly because many of them are not articulated in the standard forecasting models used to assess such shocks.

22. The second issue concerns the ways in which the Asian economies will attempt to address their problems. Their basic problem is to be able to service and repay their foreign debts. They could obtain the necessary funds by borrowing more money, but this does not appear feasible at the present time; so they will have to boost exports and/or cut imports in order to generate the necessary foreign exchange. Since there are likely to be social constraints on the extent to which imports can be cut, most of the adjustment is therefore likely to come from increased exports; but that increase in exports must find a higher level of demand elsewhere in the global economy. However, it is not clear where such a demand will come from. As noted above, the United States economy is expected to slow down this year and in Western Europe, where macroeconomic policies are focused on meeting the requirements for EMU membership and are unlikely to be relaxed, growth is set to remain more or less unchanged from last year. In this situation, the greatly increased competitiveness of Asian exporters may lead to a much sharper fall in the trade balances of the developed market economies than is currently expected. For Western Europe and Japan, this would imply a reduction in their trade surpluses and for the United States a larger trade deficit – although for Japan the opposite appears to be happening. Since the trade links of Asia are much stronger with the United States than with Western Europe, and given that the Japanese economy, a major outlet for Asian exports, may hardly grow at all in 1998, most of the increase in Asian exports is likely to go to the United States. This might not seem to present a major problem given the current strength of the United States economy – but the current strength may be deceptive.

23. One of the principal driving forces of growth in the United States over the last few years has been consumer spending; and this in turn has been supported by rising employment, increased real incomes, and the wealth and income effects of a booming stock market. However, expenditure of households has persistently been running ahead of their disposable income since 1994 and they have achieved this by reducing the figure expressing their savings as a proportion of income to its lowest level (3.8 per cent) since the Second World War and by heavy borrowing. At the end of 1997, household debt was equivalent to about 85 per cent of personal disposable income, a level which involves a heavy burden of debt servicing. This entails a situation where even small reductions in income or in lending by the banks and other financial institutions can lead to sudden cuts in consumer spending as borrowers anticipate that they may not be able to finance their debts. The reduction in incomes could arise from the larger-than-expected subtraction of net imports from domestic output or from a reduction in lending by institutions that might be anticipating the slowdown in income growth or adjusting their portfolios for possible losses in connection with their previous lending to the Asian economies. The net result – unless offset by increased

Table 4

International trade and external balances of the ECE transition economies, 1995-1997

(Rates of change and shares: percentage)

	Merchandise exports in dollars (growth rate)			*Merchandise imports in dollars (growth rate)*			*Trade balance (percentage of GDP)*			*Current account (percentage of GDP)*		
	1995	*1996*	*1997*	*1995*	*1996*	*1997*	*1995*	*1996*	*1997*	*1995*	*1996*	*1997*
Eastern Europe	27 7	2 3	5 8	32 3	13 8	5 0	-6 3	-9 5	-9 8	-0 3	-3 8	-3 9
Albania	45 5	4 4	-38 4	18 4	40 0	-47 5						
Bosnia and Herzegovina	..	144 7	32 8		129 9	-1 2						
Bulgaria	34 3	-8 8	-1 9	35 1	-10 4	-13 6	-2 3	-1 9	4 0	-0 2	0 2	4 3
Croatia	8 7	-2 6	-3 8	43 6	3 7	17 1	-15 3	-16 6	-25 7	-6 8	-4 5	-7 0
Czech Republic	33 6	1 2	2 8	45 0	9 7	-2 7	-7 2	-10 3	-8 4	-2 7	-7 6	-6 0
Hungary	20 2	2 2	21 4	6 3	4 8	16 3	-5 8	-5 4	-4 5	-5 6	-3 7	-2 2
Poland	32 8	6 8	6 4	34 7	27 9	13 2	-5 2	-9 4	-11 8	4 6	-1 0	-3 2
Romania	28 6	2 2	5 6	44 6	11 3	-2 0	-6 6	-9 4	-7 7	-5 0	-7 2	-6 1
Slovakia	27 9	3 0	-0 5	32 3	26 9	-7 8	-1 1	-12 1	-7 6	3 7	-11 1	-7 7
Slovenia	21 8	-0 1	0 8	30 0	-0 7	-0 7	-6 3	-5 9	-5 5	-0 1	0 2	0 6
The former Yugoslav Republic of Macedonia	10 8	-4 7	3 0	15 8	-5 4	8 0	-12 8	-12 2	-17 8	-5 5	-7 3	-6 3
Yugoslavia		20 3	28 6		53 9	17 0	-12 2	-14 1	-13 4			
Baltic States	35 2	17 6	22 2	41 7	26 0	26 1	-15 4	-18 6	-22 5	-5 8	-8 3	-8 5
Estonia	40 6	13 1	39 5	53 0	26 2	37 3	-19 5	-25 9	-32 8	-5 1	-9 7	-9 2
Latvia	31 9	10 7	15 8	46 6	27 6	17 3	-11 5	-17 4	-19 1	-0 4	-5 6	-7 9
Lithuania	33 3	24 0	14 3	31 0	24 9	22 7	-15 8	-15 3	-19 4	-10 3	-9 2	-8 7
CIS	27 7	10 3	1 4	24 4	6 0	17 9	7 7	7 3	5 3	2 2	2 5	0 5
Armenia	74 1	60 6	-15 0	80 9	70 0	2 6	-18 6	-26 1	-29 0			
Azerbaijan	-7 0	-3 1	20 2	50 7	41 1	-29 1	-3 6	-8 8	-0 8			
Belarus	72 2	6 3	1 4	93 5	25 6	17 1	-1 1	-3 5	-6 5	-5 5	-3 7	-6 4
Georgia	48 7	21 2	60 7	253 2	80 3	42 2	-5 2	-8 2	-9 7			
Kazakhstan	72 7	17 7	27 5	-15 3	10 5	51 9	7 0	7 0	6 9			
Kyrgyzstan	19 7	-20 0	141 1	56 5	107 6	-25 9	-1 9	-13 4	0 6			
Republic of Moldova	74 4	-8 4	-17 8	48 5	52 7	31 3	0 5	-9 6	-17 9	-8 1	-12 9	-18 0
Russian Federation	23 9	8 7	-1 6	17 0	-4 9	22 3	9 1	9 0	6 4	3 0	3 3	1 4
Tajikistan	24 4	-11 6	7 0	5 7	-13 9	5 0	35 3	14 6	18 4			
Turkmenistan	92 5	-42 1	-51 0	-20 8	49 3	-43 7	9 0	-20 3	-17 0			
Ukraine	32 6	13 0	22 1	88 7	18 8	4 7	1 8	1 0	3 4	-3 1	-2 7	-2 3
Uzbekistan	77 2	94 0		35 6	96 0		0 8	0 9				
Total	**27.9**	**6.2**	**4.5**	**30.4**	**12.0**	**9.2**	**1.4**	**0.3**	**-0.9**	**0.9**	**-0.2**	**-1.4**
Memorandum items												
CETE-5	28 8	3 1	6 5	30 5	15 4	5 8	-5 5	-8 9	-9 2	0 9	-3 4	-3 7
SETE-7	23 5	-0 7	3 2	39 1	9 6	2 6	-8 9	-11 2	-11 8	-4 6	-5 4	-4 4

Sources: National statistics, Commonwealth of Independent States (CIS) Statistical Committee and direct communications from national statistical offices to the Economic Commission for Europe (ECE) secretariat computations.

Note: Foreign trade growth is measured in current dollar values. Trade and current account balances are related to GDP at current prices, converted from national currencies at current dollar exchange rates. Trade values include the "new trade" among the successor States of the former Czechoslovakia and the former Socialist Federal Republic of Yugoslavia, but not intra-CIS trade. Current account data for 1997 are a combination of full year results, estimates or official forecasts in the case of the Eastern European countries, and January-September 1997 values for the Baltic and CIS States. Current account data for the Russian Federation for 1997 refer to relations with the "far abroad" (non-CIS countries) only, whereas those for other CIS countries cover all external relations (non-CIS and CIS). Current-price GDP values are in some cases estimated from reported real growth rates and consumer price indices. On regional aggregates, see the note to table 3.

Two dots (..) indicate data not available.

demand from the government sector or from abroad – would be a scramble to reduce household indebtedness and a sharp deceleration in the growth of GDP. If neither of these possibilities were to materialize, there would presumably be increased pressures for protection against higher levels of imports.

24. At present, the outlook for the Western European economies encompasses only a modest improvement in the average rate of growth in 1998, an improvement that assumes that the growth in domestic demand will offset a weaker contribution to growth from net exports. However, the recovery of domestic demand is still somewhat hesitant, especially in Germany, and a more rapid deceleration in export growth than is currently forecast might therefore have a more serious effect on expectations than in circumstances where growth was already well established at a higher rate than at present. A weaker performance in Western Europe would then have negative consequences for the transition economies.

25. The probability of such a scenario's becoming actual is obviously difficult to determine but it is certainly not zero and it is at least sufficiently high to concern the Chairman of the United States Federal Reserve.[10] Nevertheless, the likelihood will be reduced if policy makers are at least prepared to implement appropriate measures to accommodate the increase in Asian exports. It might also be prudent to ensure that the International Monetary Fund (IMF) is provided with the funds it has requested to deal with the possible consequences should global demand not be sustained.

26. In Western Europe, however, the preparations for the introduction of a common currency on 1 January 1999, like any major institutional change, are bound to inject a large measure of uncertainly into the economic outlook in the next year or so. Although a strengthening in the growth rate of the European economy is an important requirement for increasing popular support and acceptance of the new monetary regime, it is by no means clear that policy initiatives would be forthcoming to offset any faltering in the recovery of domestic demand.

D. The Euro *ante portas*

27. On 2 May 1998, the European Council will decide[11] which member countries of the European Union (EU) will adopt a common currency – the Eurodollar (Euro) – as from 1 January 1999. On the same day, the bilateral conversion rates of the national currencies of participating countries will be fixed, a move that is designed to discourage speculative attacks in the interim. The rates of conversion[12] of national currencies to the Euro will be irrevocably fixed on 1 January 1999 and from that day on EMU will become operational. The single monetary policy of EMU will be conducted by the European Central Bank (ECB). National currencies will become subunits of the Euro. Circulation of Euro banknotes and coins will start, at the latest, at the beginning of the year 2002, and by 1 July 2002 national banknotes and coins will cease to be legal tender.

28. At this time, the time of the writing of the *Economic Survey of Europe, 1998*, it is virtually certain that the third stage of EMU will start with 11 countries, namely, Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain. According to the European Commission, these countries have achieved the necessary degree of convergence in terms of inflation, long-term interest rates, government budget deficits and government debt. In addition, they have met the exchange-rate requirement, that is to say, their exchange rates have remained stable within the normal fluctuation margins of the exchange-rate mechanism (ERM) of the European Monetary System (EMS) for the last two years.[13] Among the remaining four EU countries, Denmark, Sweden and the United Kingdom have announced their intention not to participate in the third stage of EMU from its inception, but they have not excluded the possibility of membership at a later date. Greece is judged to be not yet in compliance with the convergence criteria.

29. The current EMS, which will cease to exist at the end of 1998, has been described as the "most significant and effective international exchange rate arrangement operating since the breakdown of the Bretton Woods".[14] Its phasing out and the beginning of EMU in 1999 constitute a watershed in post-war European history.[15] EMU is a project driven essentially by political and historical considerations, and the primacy of politics is repeatedly stressed by the leaders of the member countries of EU. Nevertheless, the implications and consequences for European economies and for economic policies are obviously considerable, and it is with some of these that the following paragraphs are concerned.

30. The adoption of a single currency can be seen as a complement to the single market, and it is intended to further deepen the economic and financial integration of the European countries. Whether the Euro will also be a vehicle to accelerate the political integration of EU remains to be seen. In any case, the emphasis of the Maastricht Treaty on European Union on nominal economic convergence has led to an asymmetry in the development of the monetary and political integration of EU countries. In fact, a monetary

union without political union is virtually unprecedented for such a large, heterogeneous group of industrialized economies.[16] It is important to note that there are no legal provisions for an orderly exit of a country from EMU.

31. While there will be a single monetary policy in EMU, economic, fiscal and social policy remains largely within the competence of national Governments. The new ECB will be in charge of monetary policy in the Euro-zone from the beginning of 1999. Its primary objective is to maintain price stability. The monetary policy strategy for stage three is still to be decided, with a basic choice to be made between monetary targeting and direct inflation targeting. A major uncertainty surrounds the characteristics of the average monetary policy transmission process in the Euro area,[17] given, *inter alia*, the significant differences in financial structures of the EU countries. Also, a new exchange-rate mechanism (ERM2) will, in principle, link the currencies of the EU countries that are outside the Euro-zone (the so-called pre-ins) to the Euro; but it is not clear whether all four of the countries will actually be prepared to enter this mechanism as from the beginning of 1999.

32. The scope for independent national fiscal policy will in practice be constrained by the provisions of the Stability and Growth Pact, which was concluded at the Amsterdam European Council in June 1997. The Pact clarifies the so-called excessive deficit procedure of the Maastricht Treaty; it defines the adverse economic conditions under which a budget deficit may exceed 3 per cent of GDP; and it provides for the imposition of sanctions or fines if this ceiling is exceeded in "normal" times. The Pact orients fiscal policy towards a balanced budget or a budget surplus in order to provide a sufficient margin for the working of automatic stabilizers in case of an economic downturn. A major rationale of the Pact is to reduce the risk of an adverse policy mix, which could put an excessive burden on monetary policy in regard to offsetting the inflationary pressures associated with "excessive" government spending. It is designed to prevent the accumulation of high levels of government debt and the risk of pressures for inflationary debt bailouts. More generally, the Pact can be regarded as a partial substitute for policy coordination and a common "stability culture".[18]

Costs and benefits

33. The economic costs and benefits of the shift to a single currency are well known from the theory of monetary integration and the theory of optimum currency areas.[19] Benefits arise mainly at the microeconomic level by the elimination of those transaction costs arising from the need to exchange national currencies against those of other countries in the union. A common currency should also reduce the segmentation of markets by increasing price transparency. This should lead to more intensive competition with associated benefits for final consumers of goods and services. A common currency will also eliminate exchange-rate uncertainty within the monetary union and hence remove the costs of foreign exchange hedging. In theory, reduced exchange-rate uncertainty could have a positive effect on output growth, but the empirical link between exchange-rate uncertainty and economic growth has been found to be rather weak.

34. The main cost associated with a monetary union is the loss of control over the domestic money supply and therefore over interest rates as a policy instrument. It also means the loss of exchange-rate flexibility as an adjustment mechanism for dealing with long-lasting asymmetric shocks, to wit, adverse economic events that affect individual countries to different degrees. A single monetary policy also implies a much reduced scope for differences in inflation rates among countries. To the extent that inflation ranks differently among the economic policy objectives of the countries in the Euro-zone, their expected net benefit from a monetary union will vary accordingly.

35. The need for nominal exchange-rate adjustments, to wit, a devaluation, in the event of an adverse economic shock can, however, be offset by flexible labour and product markets. The nominal exchange rate can be seen as an instrument for changing the real exchange rate without adjusting nominal wages. Without this instrument, there must instead be price and quantity adjustments in the product and labour markets of individual countries. This is why European policy makers have been stressing the importance of flexible labour markets and product markets in the monetary union. If prices and wages are not flexible, then the full burden of the adjustment will have to be borne by quantities -- with severe consequences for the labour market. In other words, downward wage flexibility is of vital importance for the success of EMU.[20]

36. Another dimension of flexible labour markets is labour mobility. In contrast to the United States, labour mobility has been traditionally rather limited in Western Europe, both within and between countries, largely for cultural and linguistic reasons. In any case, labour mobility itself is not costless and is also dependent on a flexible market for housing. Labour mobility is unlikely to be able to significantly reduce the need for more wage flexibility and will only be efficient in the case of permanent asymmetric shocks.

37. An alternative adjustment mechanism would be a fiscal redistribution system with counter-cyclical transfers between regions and a central Government. The EU budget, however, is relatively small, corresponding to only some 1.2 per cent of the combined gross national product (GNP) of member countries, and it is unlikely that proposals to enlarge the scale of transfer payments will find the necessary political support. It has also been argued that in view of the redistribution system that already exists within the various countries of EU, the potential to provide additional interregional insurance against asymmetric shocks is relatively modest.[21] In any case, while fiscal transfers might cushion the consequences of an adverse shock, they would not remove the eventual need for an adjustment of relative prices and wages.

38. Apart from fiscal transfers, there is the more general question of the appropriate policy mix. With a centralized monetary policy focusing on price stability, the scope for a flexible use of fiscal policy in the individual countries to offset adverse shocks becomes, in principle, all the greater. This is particularly so in the case of limited downward flexibility in nominal wages; but the Stability and Growth Pact limits the room for manoeuvre of fiscal policy and could even restrain the operation of automatic stabilizers when they are needed.

Impact of the Euro

39. The adoption of a single currency will lead the European economies into uncharted territory, making it virtually impossible to gauge the impact on EMU members and the global economy at large. This amounts to a fundamental change in the international monetary system, with three of the Group of Seven (G-7) countries giving up their national currencies. What role the Euro will play as, for example, an international reserve currency, and how important Euro-denominated financial assets will be in the portfolios of international investors are largely matters of speculation. It also remains to be seen how strong the Euro will be relative to the dollar and the yen and whether the dollar-Euro exchange rate will be more or less volatile than the dollar-deutsche mark rate. Similarly, it is difficult to judge the likely relative stability of the real effective exchange rate of the Euro.

40. Inside the Euro-zone, the focus of cyclical analysis will shift from country-specific developments to the (weighted) averages of economic variables for the member countries. This pertains notably to inflation performance relative to the inflation target of monetary policy. There will be only a single short-term interest rate, which may not always be appropriate for all countries in the event of diverging cyclical developments. Another open issue is the impact of monetary policy on the average change in output and demand in the Euro-zone and the variation in these effects between the individual countries.[22]

41. At present, there is in fact quite a marked degree of cyclical desynchronization among the prospective EMU members (see chap. 2.2 (i) of the *Economic Survey of Europe, 1998*). In countries such as Finland, Ireland and Spain which are more advanced in the business cycle than other countries, especially Austria, Belgium, France, Germany and Italy, inflationary pressures are larger and there might, in principle, be a need for higher interest rates; but higher interest rates would not be appropriate for the latter group, at this stage. Earlier expectations that short-term interest rates would converge somewhere at the mid-point of the range between the low and high interest rate countries appear to have been revised; it is now expected that they will decline to French and German levels. This will provide an additional monetary impulse to economic activity at the "periphery", which will be felt, with a lag, in the course of 1999. If it persists, this cyclical desynchronization will not facilitate the task of ECB. In any case, from the outset ECB will have to convince the financial markets of its credibility in terms of being able to meet its inflation target.

42. Fiscal policy in the Euro-zone will have to remain tight for some time to come. In many countries, either budget deficits are close to 3 per cent or debt levels are significantly above the norm of 60 per cent of GDP in 1997. The structural budget deficit for the EU member States is estimated to have been 2 per cent of GDP in 1997 with no significant reductions projected for 1998 and 1999.[23] Under such circumstances, the fact that the Stability and Growth Pact may become a problem even in the event of only a slight cyclical setback could mean having to test the provisions of the Pact at an early stage and when the new ECB is still being required to establish its credibility.[24] This almost certainly implies continuing fiscal retrenchment in EMU countries to avert the embarrassment of sanctions' or fines' having to be imposed should the provisions of the Stability and Growth Pact be violated. The macroeconomic costs of the Pact will only begin to wane once a comfortable budget surplus has been achieved.[25] The reduction of budget deficits does not, of course, have to rely only on fiscal retrenchment. As illustrated by the experience in the United States, a sustained and strong rate of economic growth is the most conductive environment for budget consolidation; but in Western Europe this also requires a better balance between domestic and external growth forces. To achieve

sustained economic growth, labour-market reforms alone are unlikely to suffice.

43. Unemployment in the future Euro-zone is still very high, and a large part of it is widely regarded as structural although, as suggested earlier, this may well be exaggerated. The Euro will undoubtedly intensify competitive pressures in the labour markets. It is hoped that labour markets will become more flexible, in the sense that nominal wages will not be rigid downwards and that labour mobility will increase; but the European experience over many decades does not encourage optimism in this respect. The adjustment burden that will be put on the labour market could therefore be considerable and could erode popular support for the Euro; it could even be the source of major social and political tensions should the labour-market situation continue to deteriorate. Also, if workers are not mobile and wages are not flexible there will then be increased pressures for interregional transfers, to which several member Governments are at present adamantly opposed.

44. In general, the net economic benefit from a monetary union, other things being equal, will decrease with increasing heterogeneity in the economic structures of member States, and in their monetary policy preferences, and with increased asymmetry in the economic shocks experienced. The less efficient are the adjustment mechanisms in the goods and labour markets and in the fiscal system, the larger will be the potential for tensions and the smaller the net economic gain to be reaped from a single currency.[26] Since EMU clearly will not constitute an optimum currency area, the question is whether all its members will benefit from the union to the extent that they expect and how such benefit might compare with that derived from the existing monetary policy and exchange-rate arrangements.

E. "Catching up" in a global economy: sustaining growth in the transition economies

45. The difficulties experienced recently in certain emerging markets (including some transition economies) have brought to the forefront of public debate some new aspects of the dichotomy between growth and stability, especially during a turbulent process of structural change. Recent developments have pointed to the emergence of several new dimensions of the concept of economic stability in an environment of global financial markets characterized by volatile capital flows.

46. The countries that are undergoing a profound transformation from a planned to a market economy face numerous serious challenges arising from this fundamental change. Since the issues have been the focus of wide public, academic and policy debates in recent years, the following discussion will concentrate only on some of them – those that appear to require a certain degree of reconsideration in the light of recent developments.

47. One of the central issues that underlie, explicitly or implicitly, the very concept of economic transformation is that of catching up with the developed market economies. During their long insulation from world markets, the former centrally planned economies fell steadily behind the levels of development of the Western economies owing to the inefficiencies embodied in their economic system. Their full-fledged reintegration into the world economy requires a catch-up, in the first place, in terms of productivity. The transition economies need to achieve substantial gains in productivity in order to be able to persist in maintaining for some time higher rates of economic growth than those prevailing in the developed market economies. Given the aspiration of a large group of European transition economies to join EU, this can also be regarded as an explicit policy target, since one of the fundamental prerequisites of a successful and smooth accession is a significant narrowing of the existing income gap between the transition economies and the present members of EU.

48. The issue of growth during the transition and of the factors that affect it has also been widely discussed by professional economists and in international bodies.[27] However, most of this discussion has tended to focus on the potential of the transition economies to achieve the required productivity gains and to maintain relatively high rates of economic growth over a long period of time (the prerequisite of a catch-up's occurring in the first place). The issue of sustainability has also been addressed but mostly as regards the underpinning of the supply and demand factors of growth, and not so much from the point of view of maintaining simultaneously high rates of growth and systemic stability in a volatile global environment. The recent financial crises have drawn attention precisely to the latter aspect of the catching-up process.

49. Owing to the generally obsolete, inefficient and insufficient productive capacities in the transition economies and to their generally limited domestic financial resources, they need to raise additional resources from abroad in order to obtain the required productivity gains. Indeed, with the strengthening of economic recovery, there has emerged a systematic lag between the growth of total domestic output and the growth of final domestic demand. The gap has been

covered by foreign capital which has surged into many transition economies. This imbalance – which is common in periods of fast recovery or of catching up – is one of the main reasons for the chronic trade and current account deficits that have emerged in the majority of the transition economies.

50. Current account deficits are not unequivocal threats to growth and stability since they can be sustained for long periods, provided that the country remains a net source of attractive business investment opportunities. In such a case, the country will import capital to close the domestic savings-investment gap (which results in the persistent current account deficit). As long as the main conditions that determine such attractiveness are preserved, the economy may grow and remain stable, despite the persistent disequilibrium between domestic output and domestic absorption. Actually, this is a model of development that has been followed in many fast-growing developing economies, including some of the "tiger" economies in Asia. However, the recent financial crises have raised some new concerns about the systemic stability of such a growth model in an international environment of volatile capital flows.

51. There are a number of stability-related issues stemming from the problems of financing persistent current account deficits.[28] One of the relatively recent developments, which has a direct impact on overall stability, concerns the fact that with the globalization of financial markets the volatility of capital flows has increased substantially. Moreover, the major share of global financial flows are practically beyond the reach of national and international policy-making. It is this considerable volatility of capital flows that may require some reconsideration of the mechanisms for maintaining financial and economic stability, since a high exposure to foreign capital carries an inherent risk of negative shocks to the economy owing to a reversal of the capital inflow, which is possible even when the economic fundamentals are sound and policies are coherent.

52. In addition, there are some other aspects of stability to be considered when growth is predominantly export-led and based on a narrow range of specializations. In such cases, a country may be more susceptible to external demand shocks, and the transition economies appear to be especially vulnerable in this respect. The problem is both developmental and structural in nature. A mismatch between the growth of output and that of domestic demand is not unusual during a process of catching up and very often it has highly specific compositional characteristics. The apparent excessive domestic demand often reflects domestic supply-side constraints, namely, the fact that domestic production is not in a position to meet or respond to the growing demand for certain products (for example, sophisticated technological and other investment equipment, high-quality consumption goods, and so forth). This indicates a significant discrepancy between the composition of domestic output and that of domestic demand as well as between exports and imports. It is this compositional mismatch that makes it difficult – if not impossible – to substitute domestic demand for export demand in the event of a disturbance on foreign markets. In such a situation, a fall in export demand would translate into a full-scale negative demand shock.

53. The exposure to this type of demand shock will be greater if the composition of exports is dominated by products that are subject to cyclical fluctuation (such as basic commodities and raw materials which are often subject to pronounced cyclical variations in both prices and real demand). Thus a catch-up process that includes a general upgrading and diversification of the product and export structure – as well as of export markets – would at the same time reduce the overall degree of vulnerability to external shocks. Recent changes in the composition of trade[29] suggest that the beginnings of such a process may be under way in some of the more advanced transition economies. Conversely, the longer the transition economies depend largely on unprocessed or semi-processed goods for their export earnings (as many of them still do), the longer they will be subject to adverse demand effects on their external markets.

54. Finally, there appear to be some limitations on the set of policy measures available to policy makers in the transition countries in respect of coping with equilibrium issues during the catch-up process. The main problem – which limits the efficiency of supply-side policies in these circumstances – is that, *ex ante*, it is not clear in what direction the final demand components will change in response to changes in output.[30] Basically, this leaves the authorities with the traditional instruments of fiscal and monetary policy for curbing domestic demand and, in fact, these were increasingly employed (especially in 1997) in a number of transition countries.

55. To sum up, the countries in transition are likely to face some new challenges in the process of catching up owing to the increased volatility in global financial markets and to the inherent weaknesses of their economies; at the same time, the policy choices of the authorities of these countries in coping with such challenges may be rather limited. One of the implications is that if the authorities in a fast-growing country with a persistent external imbalance wish to reduce such a risk they may need to deliberately lower the pace of economic growth below its potentially feasible rate. This

deflationary bias may be regarded as the price of stability during a process of fundamental restructuring in a globalized economy. It should be emphasized that the present discussion of stability-related issues should not be regarded as a rejection of the case to be made for high rates of growth during the transition from plan to market. On the contrary, there is no alternative to high growth rates if catching up is to take place. The point is to draw more attention to the existence of the additional risks and problems that are associated with this process in a "global" economy and which policy makers in the transition countries will need to take into account in order to be able to set both feasible and sustainable growth targets.

Notes

[1] The region of the Economic Commission for Europe (ECE) comprises the member countries of ECE namely, the whole of Europe (East and West, and including the Baltic States), the Commonwealth of Independent States (CIS), North America and Israel.

[2] An important and detailed survey of labour-market rigidities in Europe and the United States shows that many of the alleged rigidities in Europe (including employment protection legislation and minimum labour standards) do not appear to have any significant impact on unemployment levels, while many serve a distinctly useful social purpose. Even generous unemployment benefits do not appear to raise unemployment as long as they are limited in duration and accompanied by incentives to improve the ability and willingness of the unemployed to find work. There are certain combinations of arrangements that appear to have a negative effect on employment creation but those tend to be fairly specific and do not justify a blanket condemnation of European labour-market practices as "rigid and inflexible". (See S. Nickell, "Unemployment and labour market rigidities: Europe versus North America", *Journal of Economic Perspectives*, vol. 11, No. 3 (summer 1997).)

[3] Price indices actually pick up relative price changes as well as general (inflationary) increases in prices. The former, which reflect the normal working of the market system, may become relatively more important at very low rates of overall change. Macro-policy reactions to small increases in monthly price indices might therefore frustrate the reallocative role of the price mechanism.

[4] The Czech currency crisis is the subject of a special subsection (chap. 3.2 (v)) in the *Economic Survey of Europe, 1998*, No. 1 (United Nations publication, Sales No. E.98.II.E.1).

[5] Chap. 3.6 (ii) of *Economic Survey of Europe, 1998*, No. 1.

[6] The data on the sectoral distribution of private sector employment are still fragmentary and are not available for 1997. The relative importance of services as a source of new jobs in the Czech case may be a temporary feature reflecting the delays in restructuring enterprises in the industrial sector.

[7] The crisis in Asia and its possible effects on ECE member countries are discussed at length in chap. 2.1 (ii) of the *Economic Survey of Europe, 1998*, No. 1; for the impact of the crisis on flows of foreign direct investment (FDI), see chap. 3.2 (ii).

[8] See chap. 3.2 (ii) and 3.6 (vi) of the *Economic Survey of Europe, 1998*, No. 1.

[9] The global financial markets appear to have decided that the worst is over but, since one lesson of the Asian crisis (and that of Mexico before it) is that many international investors do not look very closely at the fundamentals of the real economies in which they place other people's funds, perhaps such a response should not be relied upon too heavily.

[10] In testimony before the Committee on Banking and Financial Services, United States House of Representatives, 30 January 1998, Chairman Alan Greenspan warned that "the upset in East Asia could have unexpectedly negative effects on Japan, Latin America, and eastern and central Europe that, in turn, could have repercussions elsewhere, including the United States. ... while the probability of such an outcome may be small, its consequences, in my judgement, should not be left solely to chance. We have observed that global financial markets, as currently organized, do not always achieve an appropriate equilibrium, or at least require time to stabilize" (Federal Reserve Board, Internet Web site).

[11] The decision of the European Council (consisting of the heads of State or Government) will be based on a recommendation from the Council of Finance Ministers of EU (Ecofin), which will have at its disposal separate reports prepared by the European Commission and the European Monetary Institute as to how EU member countries have complied with the convergence criteria established in the Maastricht Treaty.

[12] This will depend on the exchange rates of the national currencies against the market value of private European Currency Units (ECUs) on 31 December 1998. The European Council agreed in June 1997 that references to the ECU in legal instruments will be replaced by references to the Euro at 1:1 parity; but the ECU is a basket of currencies of 12 out of 15 member States of EU and not all of those 12 will adopt the single currency at the beginning of 1999.

[13] Finland joined the exchange rate mechanism (ERM) only in October 1996. Italy, which had suspended membership in autumn 1992, re-entered in November 1996. Among the remaining EU member States, Sweden and the United Kingdom are not participating in ERM, and Greece joined only in March 1998.

[14] W. M. Corden, *Economic Policy, Exchange Rates and the International System* (Oxford, United Kingdom, Oxford University Press, 1994), p. 105.

[15] Economic and monetary union was proposed for the first time in the Werner report in 1970 for the then members of the European Community. The basic vehicle for this was the narrowing of exchange-rate fluctuations, which led to the "snake" in April 1972; but the fact that France, Italy and the United Kingdom had left the snake by 1974 basically marked the end of the Werner process. The current European Monetary System (EMS) was created in 1979. Plans for a

monetary union re-emerged in 1988. In 1989, the Delors report proposed to move to monetary union in three stages; the Maastricht Treaty of 1991 then provided the legal framework for moving towards a common currency. For an overview, see D. Gros and N. Thygesen, *European Monetary Integration* (London, Longman, 1995); and W. M. Corden, op. cit., pp. 150-152.

[16] The main precedents are the Latin currency union and the Scandinavian monetary union. The first was founded in December 1865 by France, Belgium, Italy and Switzerland. Greece joined in 1868. This union fell apart de facto during the First World War, but it was dissolved formally after Belgium left the union at the beginning of 1927. The Scandinavian monetary union had Denmark, Norway and Sweden as members. It was created in December 1872 and ended in 1924. See T. Theurl, "Währungsunionen ohne politische Integration: die Lateinische und die Skandinavische Münzunion", *Deutsche Bundesbank, Auszüge aus Presseartikeln*, No. 76 (10 November 1995), pp. 4-12.

[17] European Monetary Institute, *The Single Monetary Policy in Stage Three* (Frankfurt am Main, January 1997).

[18] M. Artis and B. Winkler, "The Stability Pact: safeguarding the credibility of the European Central Bank", *National Institute Economic Review*, No. 163 (January 1998), pp. 87-98. In December 1997, the EU member States agreed to set up a body – known as Euro-X-Council – where ministers of countries in the Euro-zone would discuss matters of common interest. It remains to be seen to what extent this body will become an effective mechanism for informal policy coordination. In any case, Ecofin will remain the only decision-making body for European economic issues.

[19] See, for example, P. De Grauwe, *The Economics of Monetary Union*, 2nd rev. ed. (Oxford, United Kingdom, Oxford University press, 1994); and W. M. Corden, op. cit. There is no single set of criteria that would determine the optimal size of a currency union but there is general agreement that it must involve a degree of factor mobility sufficient to avoid the need for exchange-rate adjustments, that is to say, high capital mobility would enable current account deficits to be financed without the need for depreciation of the exchange rate and high labour mobility would enable a country in deficit to deflate its economy without creating large-scale unemployment. A high degree of financial integration is a corollary of the capital mobility requirement. Other factors that have been singled out in the large literature on this subject as influencing the optimal size of a currency union include the degree of openness of national economies (the ratio of tradable to non-tradable goods and services) and the degree of product diversification of exports and imports.

[20] W. M. Corden, op. cit., p. 130.

[21] Antonio Fatás, "Does EMU need a fiscal federation?", *Economic Policy* (Oxford, United Kingdom), No. 26 (April 1998), pp. 165-203.

[22] There have been marked differences in the real effects of monetary policy among the EU countries in the past, but the differences in the transmission of monetary policy can be expected to narrow in the Euro-zone. See R. Ramaswamy and T. Sloek, "The real effects of monetary policy in the European Union: what are the differences?", *IMF Working Paper* (Washington, D. C., December 1997).

[23] *OECD Economic Outlook* (Paris, December 1997), annex table 31.

[24] M. Artis and B. Winkler, loc. cit.

[25] Barry Eichengreen and Charles Wyplosz, "The Stability Pact: more than a minor nuisance?", *Economic Policy* (Oxford, United Kingdom), No. 26 (April 1998), pp. 67-113.

[26] J. von Hagen, "Monetare, fiskalische und politische Integration: Das Beispiel der USA", *Deutsche Bundesbank, Auszüge aus presseartikeln*, No. 76 (10 November 1995), pp. 13-21.

[27] Previous issues of the *Survey* have discussed in detail the factors of growth during the transition both from the supply and from the demand side. See *Economic Survey of Europe in 1996-1997* (United Nations publication, Sales No. E.97.II.E.1), chap. 3.2 (ii) (b), entitled "Demand-side factors of growth in the transition", and *Economic Survey of Europe in 1995-1996* (United Nations publication, Sales No. E.96.II.E.1), chap. 3.2 (i) (b) entitled "The supply-side determinants of growth in the transition".

[28] Some of these problems are analysed in more detail in chap. 3.2 (iii) of *Economic Survey of Europe, 1998*, No. 1. See also *Economic Bulletin for Europe*, vol. 49 (1997) (United Nations publication, Sales No. E.97.II.E.23), chap. I.3 (v) entitled "External imbalances and financial vulnerability".

[29] See chap. 3.6 (ii) of *Economic Survey of Europe, 1998*, No. 1.

[30] As regards the transition economies, these limitations partly arise because of the instability and heterogeneity of the elasticities of the components of final domestic demand with respect to changes in output (see chap. 3.3 (ii) of *Economic Survey of Europe, 1998*, No. 1). Consequently, a corrective policy that directly targets supply ("supply-side policy") may not necessarily bring about the required macroeconomic correction (the closing or narrowing of the gap between the growth in output and the growth in demand).

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Summary of the survey of the economic and social situation in Africa, 1997

Executive summary

Economic performance in Africa in 1997 demonstrated once again the fragility of the recovery, and emphasized the predominance of exogenous factors in the determination of the out-turn. The rate of growth was estimated at 2.9 per cent, as against 4 per cent in 1996. This was due to a combined effect of low oil prices and weather conditions that affected agricultural output in southern and northern Africa subregions. Assuming a rate of population growth of 2.8 per cent, the overall regional per capita income posted a positive growth rate of 0.1 per cent.

On the external front, trade maintained a positive growth rate in 1997. However, debt overhang continued to pose a major obstacle to the recovery and sustainability of high economic growth, particularly for highly indebted poor countries.

Some of Africa's perennial social problems continued to be exacerbated, and malnutrition, hunger, disease, ill-health and lack of shelter were still widespread. In addition, a crisis of governance encompassing such well-known shortcomings as political accountability and transparency, policy and institutional weaknesses remained pervasive.

Policy preoccupation in 1997 focused on three distinct but interrelated and cross-cutting areas of concern to African Governments: mitigating the impact of unfavourable weather conditions on the agriculturally dependent population; maintaining the growth momentum of the last three years; and continuing to implement policy reform measures. Economic diversification and financial resource mobilization received active policy support in most countries.

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Reduction and eventual eradication of poverty continued as the overarching policy challenges facing African Governments in the foreseeable future. To that end, policy makers in Africa face the challenges of developing modalities that would make possible the attainment of high and durable growth, expansion of employment, equitable income distribution in an environment of stable prices and a sustainable balance of payments position.

The growth of the African economy is forecast to rebound to between 4.0 and 5.0 per cent in 1998. The upper bound is based on the assumption of better weather conditions, improvement in trade prices, and the prevailing of peace and stability in the region. The lower bound would be obtained if either of those three conditions fail to materialize.

The implementation of the development-oriented structural adjustment programmes in Africa, integration and globalization, foreign direct investment and the business environment in Africa are the major policy challenges that Africa will face in the immediate future.

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I. Overall performance

1. Economic Commission for Africa (ECA) revised estimates indicate that regional output increased by 2.9 per cent in 1997, compared to 4 per cent in 1996 and 2.7 per cent in 1995 (table 1). Despite that reduction in the overall rate of growth in 1997 relative to 1996, per capita income managed to increase by 0.1 per cent.

2. The aggregate mean, however, conceals the large variation in growth across a continent that is very diverse in nature. Overall, African countries' gross domestic product (GDP) in 1997 ranged between a low of -8.7 and a high of 12.7 per cent. In 31 of 53 countries, economic growth was well above population growth rates. Three countries had negative growth rates in 1997, compared to two in 1996. Nine countries posted growth rates in excess of the United Nations New Agenda for the Development of Africa in the 1990s mandate of 6 per cent. For the least developed countries, the 1996 momentum was not sustained and GDP growth decreased from 4.5 per cent to 2.4 per cent in 1997.

3. The decline in the regional growth rate was reflected in all subregions without exception (table 2). Among the subregions, growth was lowest in southern Africa, at 2.4 per cent, followed by North Africa, at 2.8 per cent. The highest rate was recorded in Central Africa, at 3.8 per cent followed by West Africa's 3.7 per cent and eastern Africa's 3.5 per cent. Relative to their 1996 performance, the largest decline was recorded for North Africa, from 4.4 per cent to 2.8 per cent, a fall of 36 per cent; followed by the southern Africa subregion, where growth for 1997 was 80 per cent of what it was in 1996.

Table 1
African economic indicators, 1993-1997
(Percentage growth rates)

	1993	*1994*	*1995*	*1996*	*1997*
GDP growth, Africa	0.0	2.0	2.7	4.0	2.9
Oil-exporting countries	-0.3	1.4	3.1	4.2	3.6
Non-oil exporting countries	0.1	2.6	2.4	3.7	2.3
Least developed countries	-4.0	-0.7	4.0	4.5	2.4
Sectoral growth rates					
Agricultural output	0.9	3.9	1.5	5.2	1.7
Mining value added	-0.5	-0.5	-0.2	6.5	3.8
Manufacturing value added	-0.8	2.9	4.5	2.5	2.5
Exports unit value[a]	-7.0	0.5	7.3	-0.9	-2.1
Imports unit value[a]	-5.6	1.0	8.7	-2.9	-1.0
Oil price (Brent crude $/b)	16.8	23.9	20.5	22.1	20.0
Non-oil commodity price[a]	2.8	22.1	5.9	-6.3	7.6
Consumer prices[a]	29.5	38.7	33.1	25.1	28.3
Terms of trade index (1990=100)	-4.5	1.2	1.5	4.6	-0.5
Purchasing power of exports	10.8	20.0	-3.4	-9.0	-8.3
Africa's share in world trade (percentage)	2.4	2.4	2.2	2.0	1.9
Current account deficit (US$ billions)	-9.7	-11.9	-16.2	-9.6	-9.4

Source: ECA secretariat.

[a] Percentage changes over previous year.

4. Inflation crept up from 25.1 per cent in 1996 to 28.3 per cent in 1997, due mainly to food prices increases and/or political instability in some countries. For example, it jumped to double digits – the highest level in recent years – in Kenya and Uganda, two countries that had earlier reduced inflation to single-digit levels, and remained high in Angola, Burundi, the Democratic Republic of the Congo, the Congo and the Sudan, where political factors disrupted production and distribution of goods. However, in the Democratic Republic of the Congo, the new Government initiated bold measures to stabilize the economy, as a result of which a 1 per cent growth rate was recorded.

Table 2
Subregional growth rates, 1993-1997[a]

	1993	*1994*	*1995*	*1996*	*1997*
North Africa	0.5	1.8	1.8	4.4	2.8
West Africa	0.5	2.5	3.4	4.2	3.7
Central Africa	-9.2	-1.3	5.0	4.4	3.8
Eastern Africa	2.4	4.5	4.9	4.3	3.5
Southern Africa	1.5	2.5	2.5	3.0	2.4
Africa	0.0	2.0	2.7	4.0	2.9

Source: ECA secretariat.

[a] Weighted average.

II. Sectoral performances

5. The strong recovery of *agricultural* output in 1996 was not sustained in 1997. Agricultural production decelerated to 1.7 per cent in 1997, after bumper crops had raised output by a record rate of 5.2 per cent in 1996. That was essentially due to the weather conditions that affected production in major producer nations and the dearth of modern technology that continues to constrain productivity. The production of major export commodities in 1997 fell below its 1996 levels, an adverse outcome that was particularly notable for cocoa and coffee. Poor harvests were particularly recorded in North, East and southern Africa subregions due to unfavourable weather conditions. Given the significance of agriculture in the African economies, smaller harvests had adverse consequences on income and on the performance of the processing industries.

6. Poor rainfall and drought in Morocco reduced its GDP growth for the fourth time in the last six years, and necessitated higher cereal imports. The El Niño-induced weather condition in southern and some parts of eastern Africa provoked critical food shortages, eliciting urgent calls for international food aid in some countries that had achieved food self-sufficiency in 1996, such as Ethiopia, Eritrea, Somalia, Rwanda, Sudan, the United Republic of Tanzania and Uganda. Modest growth was nevertheless recorded in West and Central Africa subregions, although severe food shortages were reported in Burundi, the Congo, and the Democratic Republic of the Congo. In addition to the erratic changes in weather conditions, civil strife also played a significant part in accentuating the region's food supply difficulties. According to data from the Food and Agriculture Organization of the United Nations, cereal production fell by about 10.5 per cent from 126 million tons to 113 million tons in 1997. Fruits, jute and vegetables production were slightly lower relative to 1996, while the production of pulses increased.

7. The *industrial sector* broadly defined increased by 3.3 per cent in 1997, well below the 1996 rate of 5.4 per cent, mainly due to the slowdown in the mining subsector (3.3 per cent in 1997, against 6.5 per cent in 1996). Manufacturing industries maintained their 2.5 per cent growth. The expanding industrial activities in 1997, as in recent years, were construction (5.4 per cent) and energy and water (3.1 per cent).

8. Performance indicators of the African *mining industry* in 1997 repeated results observed in 1996 despite the surge in investment. Production of 15 main minerals representing over 90 per cent of the sector's total output show that with few exceptions, output either declined or stagnated in 1997. The overall mining production index (excluding oil) remained virtually unchanged in 1997 as compared to 1996, increasing marginally by 0.6 per cent. Gold production in Ghana for the first half of 1997 increased by 10 per cent, but despite that early surge in output, production was estimated to have remained unchanged at 44.4 tons for 1997, due to considerable slowdown during the second half of the year. Some of the key factors behind that performance include power disruptions, equipment failures and the fall in the world prices. In South Africa, most mines continue to face significant productivity problems associated with working conditions, dwindling reserves and slender margins. Output in the sector fell by 0.5 per cent in the first quarter of 1997. Gold production was particularly affected due to the declining quality and quantity of ore milled. Production in 1997 is estimated at 484 tons, down from 495 tons in 1996, a decline of 2.2 per cent. The increase in copper production in Zambia was overshadowed by the steep decline in the Democratic Republic of the Congo, as a result of which regional output remained at the 1996 level.

9. The *oil sector* continued to pursue dynamic developments. The favourable conditions under which African countries offer concessions to oil companies, coupled with low exploration and production costs due to technological developments, has continued to encourage oil activities in the region. Important new oil discoveries were reported, particularly in Algeria, Angola, Egypt and Equatorial Guinea, and exploration and drilling activities have been booming across the region. Crude oil production in Africa increased from 368.42 million tons in 1996 to 378.40 million tons in 1997. Production from members of the Organization of Petroleum Exporting Countries (OPEC) increased marginally to 252.10 million tons, 2.8 per cent more than in 1996, due to the quota system imposed on member countries by the organization. Production from non-OPEC producing countries rose to 126.30 million tons in 1997 from 123.40 million tons in 1996. The new investment in the sector is expected to boost the region's output in the years ahead.

III. External sector

10. Positive developments in the external sector were recorded in 1997. The value of exports increased by 5.9 per cent due to an 8.0 per cent growth in volume. Imports continued on their upward trend at a rate of 7.6 per cent, of which 6.3 per cent was due to a welcome increase in volume and 1.3 per cent was accounted for by increase in prices. The terms of trade marginally declined by about 1.0 per cent.

11. The trade balance maintained a positive value at US$ 8.3 billion in 1997, made up of the surplus of US$ 32.9 billion of the oil exporters and the deficit of US$ 24.6 billion for the non-oil countries (table 3). Despite the regional positive trade balance, the current account deficit increased from US$ 8.6 billion of 1996 to US$ 9.5 billion in 1997. The major factors behind the persistent current account deficit is the balance on services made up of interest payments on external debt, trade-related financial services (banking and insurance), and transport (mainly shipping) services.

12. Volume of oil exports increased as a result of growth in production, particularly by the non-OPEC countries. Other exports of minerals maintained their previous years quantity of exports. Despite unfavourable weather conditions and the decline in output of agricultural exportables, export volume nevertheless increased by depletion of stock held over from previous years.

13. The debt overhang continued to impose a major obstacle to recovery and sustainability of high economic growth, particularly of the highly indebted poor countries. The overall external debt of African countries rose from US$ 340 billion in 1996 to US$ 349 billion in 1997, an increase of nearly 3 per cent. The difficulties in meeting debt service obligations are reflected by the accumulation of arrears and the strong demand for their rescheduling.

14. The alleviation of debt burden continued to be a major item on the agenda of the African policy makers and their development partners. Among those efforts, the debt initiative for the heavily indebted poor countries (HIPC) came as a welcome development since it is expected to reduce the burden of the 32 poor and highly indebted African countries. Uganda and Burkina Faso were beneficiaries of the HIPC initiative in 1997 whose debt stock was reduced by 15 to 20 per cent. Côte d'Ivoire and Mozambique are expected to be the next beneficiaries. Indeed, the World Bank and the International Monetary Fund (IMF) announced in the first quarter of 1998 that Côte d'Ivoire qualified for debt relief funding under the HIPC initiative.

Table 3
Balance of payments, 1995-1997
(Billions of United States dollars)

	1995	*1996*	*1997*
Exports	98.3	108.6	115.0
Imports	97.7	99.2	106.7
Trade balance	0.6	9.4	8.3
Services (net)	-10.7	-10.7	-10.5
Balance of goods and services	-10.1	-1.1	-2.2
Current account balance	-16.1	-8.6	-9.5
Total external financing	19.5	16.8	15.9
Non-debt creating flows (net)	5.1	7.0	11.6
Net external borrowing	14.4	9.8	4.3
Official creditors	6.2	3.2	0.5
Banks	-3.7	-2.5	-1.4
Other	11.9	9.1	5.2
Errors and omissions	-1.9	-2.4	-1.2
Changes in reserves	-1.4	-5.9	-5.2

Source: Compiled from International Monetary Fund data

IV. Social sector

15. 1997 witnessed a further exacerbation of some of Africa's perennial problems: destruction, death and displacement. Although the ingredients for those

deteriorating social and human conditions differ from one African country to another, the results are depressingly similar. Over and above this, in many African countries a crisis of governance encompassing such well-known shortcomings as popular participation, political accountability and transparency, and policy and institutional weaknesses, remained pervasive.

16. Between 1996 and 1997, the population of Africa is projected to have grown from 738 million to 759 million, currently accounting for 13 per cent of the world population. That annual increase of 2.8 per cent represents the fastest rate of population growth, with Africa being the only region of the world where population is still growing at more than 2 per cent per annum. As a result of that high population increase, the dependency ratio in Africa is the highest in the world. The population of children aged 0-14 constitutes almost 50 per cent of the total population. Africa's high dependency burden, at 92 per cent, compares unfavourably with 68 per cent in Latin America, 61 per cent in Asia, 51 per cent in North America and 50 per cent in Europe. One consequence of a heavily youthful, non-productive population in Africa is the pressure exerted on already overstretched social infrastructure and facilities, especially in the health, education and housing sectors.

17. Access to health care continued to be generally poor. Rapidly rising population levels, high rates of urbanization and the escalating threats to public health widened the gaps between supply and demand for health services. It is estimated that 90 per cent of deaths worldwide traceable to malaria have occurred in Africa, and that of the world's 23 million people living with the HIV/AIDS epidemic nearly two thirds (some 14 million) live in sub-Saharan Africa. The dearth in health and nutritional standards has brought Africa back to its 1960s levels of life expectancy. Only four countries – Algeria, Botswana, Cape Verde and Mauritius – have recorded levels above the targets in the WHO strategy "Health for All by the Year 2000".

18. The general overview of the state of education in the region in 1997 points to the following severe and persistent problems: (a) low enrolment rates; (b) wide gender and regional disparities, which increase the higher one ascends the education ladder; (c) doubts about the relevance of the curriculum; (d) poor school infrastructure (school furniture and textbooks are insufficient, libraries lack books, teachers are not motivated and so on); and (f) the lack of resources even though member States make relatively high budgetary provisions for education.

19. Although employment figures tend to be incomplete and unreliable in most African countries, available evidence suggests that the employment situation did not improve for most countries in 1997. The development of productive employment has not kept pace with the increased labour supply. The average labour force is growing at about 3 per cent per annum, and there are declining or stagnating levels of wage employment, decreasing real wages and deteriorating working and living conditions. Recent data for most countries estimated urban unemployment rates to be in the 20 to 30 per cent range, underemployment rates in the 25 to 50 per cent range, youth unemployment rates in the 25 to 40 per cent range and women's unemployment range at twice the national average. Unless determined and improved employment and development policies are implemented, the employment crisis is likely to aggravate up to the end of the first decade of the new century, with labour force growth rising to about 2.8 per cent and outpacing the annual employment growth rate of 2.3 per cent.

20. Good governance is an important antecedent to long-term socio-economic development. In 1997, the African continent continued its struggle to institute good governance practice in the form of the democratization drive started in the mid-1980s, which has gained greater momentum in the 1990s. In 1997, the struggle for good governance was manifested in some countries, including Algeria, Liberia, Kenya and Morocco. In the region as a whole, the struggle for good governance, however, is still plagued by a number of uncertainties.

21. In recent years the democratization process, albeit fragile, has gained significant grounds in Africa. In 1997 alone, there were elections in a number of African countries, including Algeria, Liberia, Kenya, Mauritania and Morocco, and a transition process to a democratic government was initiated in Nigeria. But a lack of appropriate mechanisms for transition to democratic governance, involving civil societies, underpins the fierce civil wars, internal strife and widespread political instability that are currently engulfing a number of African countries, such as Rwanda, Burundi, Somalia and the Sudan.

22. Within the framework of the Organization of African Unity (OAU) Mechanism for Conflict Prevention, Management and Resolution, OAU, along with the Economic Community of West African States, sent observers from various member States and the OAU general secretariat to observe the conduct of the elections in Algeria and Liberia. In the same year, OAU was also involved in peacemaking missions in Rwanda, Burundi, the Comoros, the Democratic Republic of the Congo (former Zaire), the Congo, Sierra Leone, Somalia, Liberia, and the Central African Republic.

V. Major policy issues and challenges

23. The main policies pursued in 1997 and during the medium term to achieve macroeconomic goals of stability, growth and employment creation remained the core objectives. The set of reform policies included financial policies (fiscal and monetary), structural reforms and social policies. Economic diversification and financial resource mobilization received active policy support in most countries.

24. In order to achieve the above objectives, Governments set themselves financial policies, including tight monetary policy, and adopted a cautious expenditure policy. Structural reforms were mainly focused on measures to promote privatization, encouraging private-sector development, reforming the agricultural sector and encouraging sustainable agricultural development, export diversification, and improving and strengthening the civil service. Almost all countries that developed programmes for social needs have focused on combating poverty by increasing social sector spending in order to improve the supply of basic health services through preventive health care and expand primary education.

25. The overarching policy challenges facing African Governments in the foreseeable future would be the reduction and eventual eradication of poverty. To that end, policy makers in Africa face the challenges of developing modalities that would make possible the attainment of high and durable growth, expansion of employment, equitable income distribution in an environment of stable prices and a sustainable balance of payments position.

26. That is a daunting task: at current estimates, close to 50 per cent of the population subsist in absolute poverty, a proportion that is expected to continue increasing into the first decade of the twenty-first century. To restrict poverty to current levels, African countries would at the minimum need to match the GDP growth rate with their population growth. Assuming that the labour force increases at the rate of population growth of 2.8 per cent per annum, they would need to create new jobs at the annual rate of 17 million just to stabilize the rate of unemployment at current levels, which are already unacceptably high.

27. During the past decade and a half, African countries have gone through the phase of adjusting their economies with the support of IMF and the World Bank. Authoritative and candid evaluation of the Enhanced Structural Adjustment Facility (ESAF) programme shows that the results were disappointing relative to programme targets and compared to the performance of non-ESAF countries.

28. Interest in and efforts at economic integration in Africa have a long history and certainly predate the current wave of globalization. Despite the commitment at the highest levels at both regional and subregional venues and the plethora of economic groupings, their performance and economic impact has remained weak, and has certainly failed to match the enthusiasm with which they were created. Factors behind the poor performance of integration schemes in Africa include undefined and/or multiple objectives, overlapping membership, supranational integrative institutions without the power to compel members to live up to their acknowledged commitments and obligations; lack of political will to cede some portion of national sovereignty; unfair distribution of gains; exclusion of the private sector in the design and implementation of these schemes; policy reversals, particularly due to balance of payment problems and revenue losses from reduced taxes; weak institutions; diverse and incongruent policies.

29. However, there is an emerging consensus that promotes economic integration as a necessary stimulus to resuscitate and reinforce the process of economic recovery and socio-economic development, and some encouraging developments have been initiated to that end. The fiscal and customs reform initiated by the Central African Customs and Economic Union is now being fully implemented. The main provisions of the reform concern excise, common external tariffs, the generalization of the preferential regime and the turnover tax levied on imports, which are being gradually applied by all member States. In West Africa, the West African Monetary and Economic Union vigorously pursued its integration programme as approved by a summit of heads of State in May 1996. That programme will result in the implementation of a common external tariff, thus achieving a customs union.

30. Despite the huge volume of foreign direct investment, Africa has failed to attract sizeable inflow compared with other developing regions. Furthermore, what limited inflows there are are concentrated in a small number of countries, including Angola, Egypt, Ghana, Morocco, Nigeria and Tunisia, and target the extractive industries.

31. There are four factors that explain the slow growth of business in Africa: lack of openness to trade, high-risk environment, low level of social capital and poor infrastructure. Those factors are attributable to some extent to government behaviour, including corruption, and tax regulation and/or high taxes. Therefore, high priority should be given to eliminating corruption and regulating taxes in all African countries in order to help business to flourish.

VI. Medium-term outlook and prospects for 1998

32. In the foreseeable future, the major determinants of the African economic performance would continue to rest on the out-turn in a number of exogenous factors: weather conditions and development in the external economic environment, the pursuit of consistent economic reforms, and progress on peace and political stability in the domestic arena.

33. Under different assumptions, the African economy is forecast to rebound to between 4.0 and 5.0 per cent in 1998, with a mean projection of 4.5 per cent. The lower and upper ceilings are based on the possible outcome of the two major determinants. The upper bound projection is based on the assumption that conducive weather conditions will prevail and trade prices will improve. The lower bound of 4.0 per cent will be obtained if either of those two conditions fail to materialize i.e., if either agricultural output or world prices turn out to be unfavourable.

34. Given the 7-to-10-year El Niño cycle, weather conditions are expected to be more favourable in 1998 than the 1997 out-turn, and therefore a considerable turnaround in agricultural output is assumed: it is expected to enjoy a 7 per cent growth rate.

35. Developments in the external sector are derived on the basis of possible out-turn in three major factors of importance to African economies. The first and the most important is world prices for Africa's exportables and importables. In addition to the global supply and demand (the usual determinants of world prices), another important factor is the possible effect of the currency crisis in East and South-East Asian countries, which in recent years have become important trading partners of Africa, as well as major competitors in the world market. The depreciation of the currencies in those countries is bringing a slowdown in their growth, in view of which, global demand for some of the major export items of interest to Africa may decline. The most important export products that may feel the impact are oil, gold and industrial minerals, such as copper. The Asian slowdown, as well as the increased output from the huge investment targeting the production of those commodities in Africa and elsewhere, are expected to exert a downward pressure on prices.

36. The second major external factor impinging on Africa's economic performance is the debt overhang. The excessive debt burden has been an important factor behind the low volume of investment, a fact acknowledged by African countries as well as the international community at large. Although the HIPC initiative is a welcome development, it nevertheless needs to be placed on a fast track to entail an effective and observable outcome. The assumptions here are that debt relief measures will prevail and that the volume of foreign exchange required to service debt will not exceed the 1997 level of US$ 33 billion.

37. The third important external component is the inflow of resources. Although the expected positive development on the debt front should contribute to the reduction of the drain on foreign exchange, it is deemed insufficient to boost investment, particularly for the non-oil exporting countries. It is expected that net transfer from bilateral and multilateral sources will at least maintain 1997 levels.

38. On the domestic front, the higher growth scenario assumes that African Governments will continue to implement growth and development-friendly macroeconomic policies, with emphasis on reducing the rate of inflation and increasing employment. Such medium-term measures will have to be consistent with the long-term objectives of reducing mass poverty, meeting the basic health, housing, educational and social needs of the population, reducing income inequality, protecting the environment, and promoting diversified and sustainable development.

39. All the above assumptions and caveats render forecasting of economic outcome hazardous. But the built-in conditions for the projected out-turn of the African economies are unexceptional and are expected to obtain.

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I. Recent economic performance and problems

A. Growth and stability

1. World economic growth remained strong in 1996-1997, averaging more than 3 per cent. A trend that began after the 1991-1993 recession thus continued. World trade growth, on the other hand, slowed considerably in 1996, though it picked up again in 1997. The world financial markets remained buoyant, with inflation and interest rates in the developed countries remaining low and the stock markets rising. Increased volatility in both the stock and foreign exchange markets, however, accompanied those trends.

2. The slowdown in world trade, particularly in sectors of major export interest to the developing countries of the region, was a factor in sharply widening the current account balance-of-payment deficits of a number of countries in the region. Although the volume of capital flow worldwide continued to rise, the inflow of capital to the developing countries of the Economic and Social Commission for Asia and the Pacific (ESCAP) region tended to decline in 1996-1997. The trade slowdown and the reduced financial flows to the region are two major elements in the international economic situation that have adversely affected the economies of the region and led some of them into serious crisis.

3. Although the trade slowdown affected most economies, the reduced private-sector financial flows affected the East and South-East Asian economies the most. The reduced aid flows, on the other hand, impinged most on the least developed and the Pacific island economies.

4. The economic performance of the least developed countries of the region (other than the five in the Pacific) generally strengthened during 1995-1996, and remained relatively strong in 1997. Under diverse circumstances and local conditions, the growth prospects remained uncertain in a number of them. Most of them, however, have been striving to stabilize their economies and to improve medium-to-longer-term growth prospects by implementing stabilization and structural reform measures. Some of them have planned to achieve growth rates of 7 to 8 per cent for the remaining years of the decade. With that objective, measures were under way to reduce budget and balance-of-payment deficits, reduce price inflation and improve saving-investment performance through greater mobilization of domestic resources. Trade, investment and financial sector reforms were being carried out to improve overall performance. The private sector was being encouraged to play a greater and more active role in the saving-investment and production processes.

5. The economic performance of the Pacific island economies continued to reflect the diversity of their economic structures, resource endowments, level of development, and ability to respond to the external and internal shocks to which they are frequently subjected. They have generally achieved less than 3 per cent rates of growth in recent years, which often do not even match population growth rates and therefore hardly allowed any improvements in living standards. The improved international prices of several commodities, such as cocoa, copra and copra oil and gold, had enabled some countries to achieve somewhat higher growth rates in 1996. But prospects in 1997 were uncertain because the prices of the agricultural commodities and primary materials on which they substantially depend showed divergent trends.

6. By 1996-1997, most of the economies of North and Central Asia had succeeded in reversing the economic decline that had prevailed since the beginning of the 1990s and to set themselves on the path to positive growth. Following positive gross domestic product (GDP) growth in Armenia, Azerbaijan, Kazakhstan, Kyrgyzstan and Uzbekistan in 1996, the Russian Federation also recorded positive growth in 1997. Turkmenistan's economy further contracted in 1997, owing to a crisis generated by huge shortfalls in the production of cotton and natural gas, with its spillover effects on the rest of the economy.

7. Their recent positive achievements reflect progress towards organizational, institutional and policy reforms, started some years ago to turn the formerly planned economies into modern market economies. The success of economic reforms was most visibly reflected in the reduction of inflation rates and the stabilization of the interest and exchange rates. With the restoration of stability, those economies are expected to receive further boosts in investment and growth through to the year 2000.

8. In South and South-West Asia, GDP growth was relatively strong and steady, at 6 to 7 per cent in 1996-1997 in India, the Islamic Republic of Iran and Turkey. In Pakistan and Sri Lanka, growth decelerated considerably in 1996, though Sri Lanka was expected to recover in 1997. The overall performance of countries in the subregion is considerably influenced by the weather conditions affecting agricultural production, given the still large share of that sector in the economy. Industrial production has responded well to recent policy reform and restructuring measures. However, industrial output expansion in many countries

remained severely constrained by power shortages and other infrastructural weaknesses. Services sectors have been more resilient, and have contributed significantly to overall growth.

9. Increased private-sector participation in investment tended to strengthen investment activities, though investment rates continued to remain generally low. Stagnant domestic savings rates and failure to attract foreign capital to any significant extent restrained investment growth. A major reason for low domestic savings rates has been high budget deficits, which countries have been seeking to reduce. Relatively high rates of inflation prevailed in the Islamic Republic of Iran, Turkey, Pakistan and Sri Lanka. India, on the other hand, succeeded in lowering its inflation rate significantly.

10. Over much of 1996 and indeed well into 1997, the South-East Asian economies continued to perform strongly, with GDP growth rates only slightly lower than the 1991-1995 average. In fact, the Philippines, Viet Nam and Brunei Darussalam achieved growth rates higher than their 1991-1995 average. But they were adversely affected by the significant deceleration in world trade growth in 1996, particularly certain sectors of importance to South-East Asian exports. Among the economies most affected, Thailand's growth rate declined by nearly 2 percentage points, though the economy still registered a GDP growth of 6.7 per cent in 1996. Singapore's growth rate also declined, from an 8.5 per cent average in the first half of the 1990s to 7.0 per cent in 1996.

11. The slowdown in GDP growth also brought into focus certain fundamental weaknesses in the economies, mainly in the widening current account deficits during the period 1994-1996. Many countries had linked their currencies primarily to the United States dollar, which has appreciated significantly since 1995 against other major currencies. The resulting appreciation of local currencies was a factor adversely affecting exports while encouraging rapid import growth. The current account deficits widened sharply in some cases, funded by continued financial flows, with a growing component of short-term debt. Over the years, those inflows caused banking assets to expand. A large proportion of loans went to unsound investment, for example, in the property sector. Oversupply in that sector and a fall in property values started a chain reaction. The financial institutions found themselves saddled with bad loans, and stock markets slid down. Ultimately, a loss of creditor confidence in the financial system and in the debt repayment abilities of countries worsened the crisis, which spread to a number of countries.

12. Their currencies came under serious pressures against which their semi-fixed links with the United States dollar were no longer defensible and were put on float during the second half of 1997, starting with the Thai baht in July. Since then, currencies have floated down precipitously, requiring some countries to negotiate packages of financial assistance from the International Monetary Fund (IMF). Prospects for growth over the next 2 to 3 years crucially depend on the length of the current crisis. Growth forecasts for all of the economies have been lowered for at least the coming 2 to 3 years. Among the three countries most affected by the crisis, Thailand expected -3 per cent growth in 1998 after -0.4 per cent growth in 1997. In Indonesia and the Republic of Korea, rates of growth are expected to be halved from those of 1997, which were already 2 to 4 percentage points lower than in 1996.

13. The economies of China, Hong Kong China and Taiwan Province of China have been the least affected by the financial turmoil in the Asia and Pacific region, although the latter two suffered bouts of instability from time to time and Taiwan Province of China had to devalue its currency by 15 per cent against the United States dollar in October 1997. The Chinese yuan renminbi and Hong Kong dollar have remained stable throughout. By far the worst affected economy in the East Asian region has been that of the Republic of Korea, which in November 1997 was compelled to apply to IMF for assistance in the face of increasingly severe pressure on the currency, the financial sector and the stock market. In response, in December 1997, IMF organized one of the largest financial rescue packages ever, amounting to $57 billion, with $21 billion in standby credits from IMF itself and the rest from other donors.

14. For China, prior to the development of the financial market turmoil the principal concern was the need to moderate inflation without overly restraining the momentum of growth, i.e., achieving a "soft landing" for its economy after more than three years of double-digit growth. This was achieved in 1996, with inflation moderating significantly and growth slowing only slightly. Problems of overheating had begun to affect the other economies of East Asia as well in 1995. The slowdown in export growth, combined with the institution of monetary restraint, reduced inflation, with growth rates by and large remaining unimpaired. In the Republic of Korea, however, the slowdown brought into sharp focus the widespread weaknesses in the corporate sector and the attendant fragility of the financial system.

Rates of economic growth and inflation in selected economies of the ESCAP region, 1996-2000

(Percentage)

	Real gross domestic product					*Inflation*[a]				
	1996	*1997*[b]	*1998*[c]	*1999*[c]	*2000*[c]	*1996*	*1997*[b]	*1998*[c]	*1999*[c]	*2000*[c]
Developing economies of the ESCAP region[d]	**7.2**	**6.2**	**4.3**	**5.9**	**6.7**	**6.7**	**6.8**	**8.8**	**7.6**	**6.7**
South and South-West Asia[e]	**6.2**	**6.3**	**6.3**	**6.5**	**6.7**	**13.0**	**11.4**	**9.2**	**8.7**	**6.7**
Bangladesh	5.3	5.7	5.6	5.8	6.0	4.0	3.9	5.0	5.0	5.0
Bhutan	6.4	5.7	5.3	7.3	8.1	9.0	8.0	7.8	7.6	7.4
India	6.8	6.9	7.0	7.1	7.2	10.0	8.0	6.0	5.0	5.0
Iran (Islamic Republic of)	5.2	5.7	2.6	3.0	3.1	23.2	18.5	20.0	25.0	..
Nepal	6.1	4.9	6.0	6.0	6.0	8.1	8.0	..	..	..
Pakistan	4.6	3.1	6.0	7.0	7.0	10.8	11.8	9.0	..	..
Sri Lanka	3.8	6.2	6.5	7.0	7.5	15.9	10.0	10.0	9.0	8.0
Turkey	7.0	6.3	5.1	4.1	5.8	75.9	80.6	59.4	53.0	43.7
South-East Asia	**7.2**	**4.2**	**1.0**	**4.1**	**5.1**	**6.0**	**8.4**	**12.6**	**10.5**	**9.1**
Indonesia	8.0	4.7	-1.5	3.5	4.0	6.5	11.1	22.5	21.5	22.0
Malaysia	8.6	8.0	4.5	4.8	7.0	3.5	2.7	3.5	3.0	2.0
Myanmar	5.8	5.0	6.5	6.6	..	16.3	29.4	25.7	24.0	..
Philippines	5.5	5.2	4.0	5.5	6.9	8.4	7.2	8.4	7.3	7.0
Singapore	7.0	7.0	4.5	6.3	7.0	1.3	1.8	2.5	2.5	2.5
Thailand	6.7	-0.4	-3.0	1.8	3.4	5.9	7.4	11.6	6.0	5.0
Viet Nam	9.3	9.0	8.7	8.8	9.0	4.5	3.5	5.0	7.0	7.0
East and North-East Asia	**8.1**	**7.3**	**5.1**	**6.8**	**7.5**	**5.6**	**5.2**	**7.9**	**6.7**	**6.5**
China	9.7	8.9	8.0	8.7	9.4	6.1	5.5	7.8	8.5	8.5
Hong Kong, China	4.9	5.4	4.0	4.4	4.4	6.0	6.1	4.6	4.2	4.1
Republic of Korea	7.1	5.9	2.0	5.2	6.2	4.9	4.5	9.0	5.3	4.8
Taiwan, Province of China	5.7	6.4	5.5	5.8	6.7	3.1	2.8	3.5	3.3	3.2
Pacific island economies	**2.2**	**0.5**	**3.8**	**2.0**	**3.2**	**8.7**	**5.6**	**4.3**	**4.3**	**..**
Cook Islands	-2.5	0.5	3.0	6.0	6.0	-0.6	-2.0	..	..	..
Fiji	3.1	1.0	3.8	4.0	3.1	3.1	3.0	3.0	3.0	3.0
Papua New Guinea	1.9	0.3	3.8	0.9	..	11.6	7.0	5.0	5.0	..
Developed economies of the ESCAP region	**3.6**	**1.0**	**1.3**	**1.6**	**1.9**	**0.4**	**1.3**	**1.3**	**0.7**	**0.8**
Australia	3.6	3.1	3.6	3.5	2.6	2.6	0.6	3.1	2.8	3.4
Japan	3.6	0.8	1.1	1.5	1.9	0.2	1.3	1.2	0.6	0.6
New Zealand	2.1	1.5	3.5	2.6	2.1	2.3	1.7	1.1	1.5	1.0

Sources:

Economic and Social Commission for Asia and the Pacific, based on International Monetary Fund, *International Financial Statistics*, vol. L, No. 9 (September 1997) and *World Economic Outlook* (Washington, D.C., October 1997); Asian Development Bank, *Key Indicators of Developing Asian and Pacific Countries 1997* (Oxford University Press, 1997), and *Asian Development Outlook 1997 and 1998* (Oxford University Press, 1997); United Nations, *Project LINK World Outlook*, 5 November 1997, and *The World Economy at the Beginning of 1998* (December 1997); The Economist Intelligence Unit, *Country Report: Myanmar (Burma)*, fourth quarter, 1997, and *Country Report: Iran*, fourth quarter, 1997; and national sources.

[a] Refers to changes in the consumer price index.

[b] Estimates.

[c] Forecast.

[d] Based on data for 22 developing economies, representing about 95 per cent of the population of the region (excluding the Central Asian Republics); GDP at market prices in United States dollars in 1995 have been used as weights to calculate regional and subregional growth rates.

[e] Estimates and forecasts for countries relate to fiscal years, defined as follows: fiscal year 1997/1998=1997 for India; fiscal year 1996/1997 = 1997 for Bangladesh, Pakistan and Nepal.

15. Of the three developed economies in the region, the economic performance of Australia remained strong, with GDP growth rates expected to exceed 3 per cent in 1997. The budget and the balance-of-payments deficits were reduced and the inflation rate was running low. Government policies were adjusted in a number of directions to correct some of the weaknesses that the economy developed, as reflected in some slowdown in GDP growth in 1997. The economies of Japan and New Zealand, on the other hand, relapsed into slower growth or stagnation in 1997. In Japan, the economy almost stagnated in 1997 after a recovery from a prolonged recession, with 3.6 per cent growth in 1996. The New Zealand economy also slowed to a growth rate of 1.5 per cent in 1997, from a level of above 2 per cent in the previous two years. A demand slump in both countries was a common cause for the slowdown, but the Japanese economy also had deeper problems in certain of its structural features and persistent difficulties in the financial sector.

16. Available data on expected/planned/forecast rates of economic growth and inflation for the years 1997 to 2000, with estimated actual rates for 1996, are given in the table for selected economies of the region.

B. Equity

17. Equity commonly features among the most important development objectives of developing countries. Accordingly, an assessment of the achievements in the region in terms of equity is undertaken in the present survey, for which purpose equity is measured in terms of reduction of absolute poverty and of inequality. The proportion of the population below the poverty line is used as the measure of absolute poverty. Two measures are used for inequality: the Gini coefficient and the ratio of income/expenditure of the top 20 per cent to that of the bottom 20 per cent.

18. The incidence of poverty has decreased in all countries of the region over the past two to three decades, but the rate of decline has slowed in some countries in recent years. That slowdown, coupled with population growth, means that in several countries there has been no change in the total number of the poor. The picture is mixed with respect to reduction of inequality: some countries have improved, there has been deterioration in a few and in others no significant time trend appears to exist. Moreover, even in some countries where significant improvement has taken place over time, there have been reversals at different points. Hence, there is still a need for continued attention to equity in all countries.

II. Policy issues

A. Policies for growth and stability

19. Most of the developing economies in the region have been pursuing policies and measures for macroeconomic stabilization and structural reforms of their economies. The basic tenet of reforms has been to liberalize the economy by removing or reducing measures of control on trade, investment and economic activities generally so as to open them to private-sector participation, both domestic and foreign. Trade regimes have been freed by the virtual removal or drastic reduction of all regulatory controls on them, as well as by a substantial reduction in import tariffs. The financial sector has been similarly liberalized to allow the private sector to provide wide-ranging financial services, by substantially easing entry restrictions into the sector and allowing the financial institutions greater freedom to set interest rates and credit allocations by using market criteria.

20. Some countries, particularly in East and South-East Asia, have gone further than others in liberalizing their economies and have enjoyed very high rates of economic growth and trade expansion over a period of a decade or more. Regarding external financial transactions, they have not only fully liberalized payments on current account but have also abolished or substantially liberalized controls on capital account transactions. Hardly any control on foreign exchange transactions has remained. Other countries, which initiated or accelerated the reform process more recently, have not yet gone as far to liberalize their trade regimes or their external financial transactions. Thus, although current account transactions have been fully liberalized in many countries, including those in South Asia, they have yet to open their capital account transactions fully and to proceed further to liberalize their trade regimes. All countries, however, have committed themselves to further reform and liberalization, not as voluntary gestures to be retracted at will but as binding commitments under World Trade Organization agreements. In the context of the current financial crisis affecting economies in the region, many countries may find it more difficult to proceed with their reform agenda, or at least may opt to proceed more cautiously.

21. The crisis in the region has served to focus attention on two crucial areas: the establishment of an appropriate exchange rate regime and the need to overcome the weaknesses of the domestic financial sector. Both issues need to be properly addressed.

22. Since the 1970s, there has been a gradual but significant shift towards more flexible exchange rate arrangements in virtually all economies. In certain cases, countries have opted for arrangements that allow frequent adjustments, such as exchange rate bands, managed floats or even freely floating rates. In other cases, countries have opted for exchange rate stability by anchoring their currencies to the United States dollar.

23. The destabilizing potential of free financial and capital flows requires countries to maintain both internal macroeconomic and external balance-of-payments stability. Large domestic deficits are clearly not favoured, and ensuring fiscal balance becomes important. The burden of ensuring domestic macroeconomic balance thus rests increasingly with fiscal policy as external openness imposes constraints on monetary policy to achieve the objectives of domestic stabilization with unintended impacts on the external sector and the exchange rate. Governments should therefore ensure that policies are compatible and avoid serious conflict of objectives, such as aiming simultaneously at a stable exchange rate, financial openness and monetary independence, the so-called "impossible trinity".

24. This implies that in financially open economies, Governments are faced with a difficult choice between stabilizing the exchange rate with a fixed parity or within a relatively narrow band of flexibility, or alternatively pursuing monetary policy for domestic stabilization irrespective of the consequences to the exchange rate under a free float. Governments in the region should opt for the most appropriate policy mix as regards the exchange rate. The current difficulties encountered by some countries in the region could have been partly the result of attempts to keep the exchange rate stable in the face of changes taking place in both the internal and external environments.

25. It should be stressed that the sustainability of a current account deficit is determined not only by its magnitude but also by the mode of financing. The greater the recourse to short-term funds, the greater the risk of reversibility if market operators lose confidence owing to dissatisfaction with any particular aspect of policy or concern about borrowers' capacity to meet repayment obligations.

26. The crisis has revealed particularly serious weaknesses in the financial sectors of many of the economies affected. This has involved not only the operations of the financial entities but also the regulatory and supervisory regimes governing them. On the one hand, the intermediating entities appear to have been unaware of or unable to gauge correctly the underlying risk of many of the investment and lending decisions they had taken; on the other, they have not had the capital strength to absorb the subsequent losses. In addition, supervisory and regulatory bodies appear to have been lax in carrying out their functions effectively, whether in the matter of banking regulation or in stock market supervision, but particularly in allowing a lack of transparency to flourish.

27. One policy implication is that countries adopt the process of financial liberalization gradually. In addition to economic fundamentals, a sound and solid financial sector prior to the liberalization of the capital account is vital. Governments in the region should establish a proper regulatory framework and more effective implementation of that framework. Equally important, proper accounting and disclosure requirements need to be in place. In particular, accounting rules regarding non-performing loans and adequate provision to cover them, the legal lending limit on insider borrowing, the consolidation of financial reports of financial and related companies in the case of extensive cross-holding and interlocking of ownership between them, and the short-term foreign debt reporting system need to be established and enforced. In their absence, any business or company evaluation and analysis rest on poor financial data and become either biased or meaningless; in effect, decisions regarding financing rely heavily on investor "confidence", which can be very fragile and volatile.

28. Governments have a critical role in putting in place proper supervisory and regulatory bodies. Governments should consider the viability of establishing an integrated supervisory framework for the financial sector as a whole. There is a growing worldwide trend to adopt such an integrated framework, recent cases being in the United Kingdom of Great Britain and Northern Ireland, Japan, the Republic of Korea and (to some extent) India. The main rationale for this is to respond to the fact that many banks, non-bank financial institutions and securities and insurance firms engage in a variety of financial transactions in different financial markets, both directly and indirectly. In the existing supervisory framework, each separate body supervises only one type of financial institution. The supervisory body or bodies also tend to be ill-equipped to monitor the financial activities of institutions and the risks involved, and hence unable to enforce prudential standards.

29. A related issue is the role of the central bank in financial supervision. Governments may consider leaving the supervisory functions to a separate autonomous body and leaving the central bank solely to conduct monetary and exchange rate policy.

30. Lack of depth and breadth of financial markets in the region have contributed to recent market turbulence.

Regional financial market integration may change that, or at least mitigate the volatility, thanks to the increasing economies of scale involved in providing financial services, so that a wider range of more efficient services can be offered to a larger number of participants in a regionalized market. Governments in the region have initiated such a scheme involving some commodity futures trading, which is essentially a financial derivative market. Governments may consider extending or replicating the scheme to other financial markets, such as the equity, debentures, derivatives and money markets.

31. The globalization process, which has been characterized by imbalances and occasional disruptions in financial markets, brings the issue of market stabilization to the fore. Although speculative activities can be useful in correcting imbalances between national or regional markets, thus promoting global efficiency in the long run, there is concern whether the short-run costs may exceed its long-run gains. Speculative transactions can be quite disruptive. The role of speculative instruments, such as hedge funds, needs to be investigated, as well as how a better framework of international surveillance and supervision could be designed to prevent undue disruption.

32. A further policy option is to slow down the adverse consequences of speculation by taxation, or "putting sand in the wheels of international finance". Governments may consider imposing taxes on local companies engaging in currency trading, particularly in the spot market. The Tobin tax proposes to levy a small globally uniform tax applied to spot transactions on foreign exchange, with the twin objectives of deterring speculative flows and allowing greater autonomy to national monetary policy. So far, international agreement has been difficult to achieve, and the idea of the tax remains academic.

33. The need for greater regional cooperation has been felt more urgently in the wake of the recent financial crises. So far, there has not been much progress on the proposed Asian fund, but it may merit a serious examination. Greater regional cooperation is also needed to address the issues and problems of financial sector regulation, the setting of common prudential standards for the industry and an early warning system for the appearance of significant non-performing banking assets or of other financial sector risks. Governments in the region may also explore the feasibility of establishing a private international credit insurance scheme dealing with cross-border financial claims (it should be noted that for foreign direct investment, there is the Multilateral Investment Guarantee Agency scheme sponsored by the World Bank, which insures foreign direct investors against political risks).

34. Financial market instability has been aggravated by perceptions of weaknesses in the financial sectors of some countries, and by the lack of reliable relevant information regarding their operations. That situation has arisen from differing standards of regulation, the lack of information regarding non-performing banking assets and the variability of standards of corporate accounting prevalent in different economies. It would appear, therefore, that arrangements capable of generating and transmitting more accurate, transparent and timely information regarding the build-up of significant financial risks within a particular jurisdiction would be very useful for authorities in another jurisdiction.

35. Much of the current crisis in the region can be traced to doubts regarding the ability of some economies to service their foreign liabilities, especially short-term debts. Doubts arose because market operators appeared to be unaware of the true extent of the affected countries' indebtedness, principally because short-term debts had not hitherto been included in the official debt data. All economies need to make substantial improvements in that area by providing comprehensive and timely debt information to counter the deleterious effects of rumour and speculation. Governments could discuss the modalities of its implementation, such as setting out common definitions and reporting requirements on a collective basis.

B. Policies for promoting growth with equity

1. Human resources development

36. The region has made major progress in human resources development, particularly in terms of indicators of health and education. However, there exists wide disparity among and within countries. Public provision or support of education and health services is crucial for the poor, who cannot afford to pay the prices charged by private providers. Additional resources will be required for expanded coverage, as well as qualitative improvements. In order to meet the cost of required investment in human resources, it will be necessary to improve systemic efficiencies, re-examine intersectoral and intrasectoral priorities, explore options for cost recovery, and secure greater involvement of the private sector, non-governmental organizations and communities in the provision of services related to human resources development.

2. Agricultural development

37. Agricultural development can play an important role in promoting both growth and equity in many countries of

the region. The policy actions required for development of this sector relate to, inter alia, technology, input and output pricing, credit, rural infrastructure and land relations. The last issue typically receives inadequate attention from policy makers. In consideration of the fact that the landless and the small agricultural households constitute the majority of the poor, efforts to provide greater access to land for the poor through tenurial as well as redistributive land reforms should be strengthened.

3. Macroeconomic stability

38. Inflation adversely affects economic growth through disincentive effects on savings and productive investment. It also exacerbates inequity by causing an erosion in the real income of the poor, thereby reducing their capacity to avail themselves of nutrition, health and educational services. Macroeconomic stability should therefore be pursued in order to foster growth with equity.

4. Demographic factors

39. High fertility is typically associated with poor families. It also adversely affects economic growth by increasing dependency ratios, which often lead to a reduction in savings and investment. Policies of fertility control should include publicly provided or publicly subsidized services relating to family planning, wider female education and better child health care. There is a need both to increase the financial resources allocated for those purposes and to enhance the efficiency of related delivery systems.

5. Small and medium-sized enterprises

40. Small and medium-sized enterprises are perceived to have several advantages compared with their large counterparts because of their ability to generate greater employment, including for women, their lower production costs and their greater utilization of local resources. They also suffer from several weaknesses that cannot be overcome without support in the form of strengthening links between large and small firms (for example, through subcontracting), facilitating modernization and technological improvement, training of entrepreneurs and managers, and provision of incentives that are time-bound and tied to appropriate performance criteria.

6. Targeted programmes

41. Targeted programmes for poverty alleviation are needed, particularly for ameliorating the conditions of those who cannot benefit from the broader policies discussed above. Some programmes in the region, such as Grameen Bank of Bangladesh, have achieved phenomenal success. Broadly speaking, however, there is a considerable need to improve the design and implementation of those programmes through better targeting of beneficiaries; ensuring the participation of the poor in project design, implementation, monitoring and evaluation; and increasing coordination among multiple programmes implemented by government agencies and non-governmental organizations and the private sector.

7. Management of short-term crises

42. Temporary crises may seriously affect lower-income groups. Such a crisis may be caused by natural factors, such as floods or droughts, external shocks, such as the sudden loss of an export market for a product leading to firm closures and unemployment, or major domestic restructuring, such as large-scale privatization. Governments need to be prepared to meet such contingencies through cash transfers, in-kind relief, public works programmes and support for self-employment.

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Summary of the economic survey of Latin America and the Caribbean, 1997

Executive summary

The Latin American and Caribbean economies put out in 1997 one of their best performances in a quarter of a century, combining an average growth rate of 5.3 per cent (compared to 3.2 per cent during the period 1991-1996) with an average rate of inflation of under 11 per cent. Per capita GDP increased by 3.6 per cent, marking an increase of 14 per cent since the start of the decade.

This growth was the consequence of a strong recovery in investment and continued expansion of exports, the latter due entirely to increases in volume. International trade showed great dynamism. Imports, however, exceeded exports and the current account deficit has widened considerably, for US$ 36 billion in 1996 to US$ 60 billion in 1997 (3.2 per cent of GDP). Nevertheless, inflows of foreign capital should more than cover the gap, totalling at least $73 billion. Of that amount, nearly two thirds was in the form of direct investment. In 1997 the region's total external debt expanded to US$ 645 billion, an increase of 2.5 per cent. External debt burden indicators reflected a general improvement; in fact, they were similar to those registered prior to the external debt crisis of the 1980s.

The restrictive fiscal and monetary policies applied in prior years helped reduce inflation to its lowest level in half a century, an accomplishment aided by sometimes overvalued exchange rates, which also contributed to the deterioration in the trade balance. In recent years, the average inflation rate for the region has dropped steadily, from 882 per cent in 1993 to 335 per cent in 1994, 26 per cent in 1995, 18 per cent in 1996 and 11 per cent in 1997, its lowest level in 50 years. Moreover, 13 of the 22 countries considered achieved single-digit inflation.

* E/1998/100.

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The employment situation has improved slightly, although the percentage of the population unemployed continues to be very high in a number of countries. In many countries of the region, economic restructuring has caused the disappearance of many jobs, which the fastest-growing sectors of the economy have not been able to replace with high-quality employment. Thus, many of the new jobs created offer neither good benefits nor job security, and real wages either grew at moderate rates or held steady. High unemployment rates are undermining efforts to move ahead more rapidly in reducing the extent of poverty – a serious problem in an otherwise generally positive scenario.

The Asian financial crisis is expected to have moderate negative repercussions in the region in terms of both trade and capital movements. In some countries, short-term capital still dominates total capital flows, which introduces a note of instability into the picture. Nevertheless, the region should be less vulnerable financially because the composition of the capital entering Latin America is more stable than it was some years ago. Moreover, the banking sector is on its way to resolving some of its problems. The most likely scenario is that in 1998 the region will return to a lower rate of growth, perhaps close to the average for the 1990s, than it enjoyed this year. In that case, the employment situation will continue to be cause for concern. On the other hand, it is likely that inflation will continue to slow, and the current account deficit may be reduced.

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I. Introduction

1. Despite the instability in international financial markets in recent months and the turbulence it has created in Latin American stock markets, in 1997 the region's economies put out one of their best performances in a quarter of a century, combining an average growth rate of 5.3 per cent (compared to 3.2 per cent during the period 1991-1996) with an average rate of inflation of under 11 per cent. Although the current account deficit has widened considerably, from US$ 36 billion in 1996 to US$ 60 billion in 1997 (3.2 per cent of gross domestic product (GDP)), inflows of foreign capital will more than cover the gap; they are expected to reach unprecedented levels, totalling at least $73 billion. Of that amount, nearly two thirds will be in the form of direct investment. The employment situation has improved slightly, although the percentage of the population unemployed continues to be very high in a number of countries. High unemployment rates are undermining efforts to move ahead more rapidly in reducing the extent of poverty – a serious problem in an otherwise generally positive scenario.

2. This growth was the consequence of a strong recovery in investment and continued expansion of exports, the latter due entirely to increases in volume, since, on average, export prices for the region remained stationary. Intraregional trade showed great dynamism, reinforcing economic interdependence between some countries, especially in the Southern Cone. Imports, however, exceeded exports; in part this was due to increased investment, as imports of capital goods increased sharply. The restrictive fiscal and monetary policies applied in prior years helped reduce inflation to its lowest level in half a century, an accomplishment aided by sometimes overvalued exchange rates, which also contributed to the deterioration in the trade balance. Thanks to the improved macroeconomic environment, Governments were able to allocate more funds to public investment and apply more flexible credit policies without undermining domestic stability.

3. As 1997 closed, the chief question was whether this relatively happy state of affairs could be maintained through the coming year. The main grounds for doubt are to be found in the external context: in prices of primary products, interest rates and foreign capital flows – the latter in particular. The Asian financial crisis is expected to have moderate negative repercussions in the region in terms of both trade and capital movements. In some countries, short-term capital still dominate total capital flows, which introduces a note of instability into the picture. Nevertheless, the region should be less vulnerable financially because the composition of the capital entering Latin America is more stable than it was some years ago. Moreover, the banking sector is on its way to resolving some of its problems.

4. Putting together the effects of the external factors, often contradictory in tendency, with macroeconomic policies adopted to reduce inflation or current account deficits, the most likely scenario is that in 1998 the region will return to a lower rate of growth, perhaps close to the average for the 1990s, than it enjoyed this year. In that case, the employment situation will continue to be cause for concern. On the other hand, it is likely that inflation will continue to slow, and the current account deficit may be reduced. In view of the determination already shown by a number of Governments to take hard measures when necessary to maintain macroeconomic stability, it seems unlikely that the Asian financial crisis will have repercussions powerful enough to provoke new foreign exchange crises in the region.

II. Macroeconomic policy

5. In the first three quarters of 1997, the countries of the region maintained the general thrust of the macroeconomic policy they had been following since the start of the decade. Improved expectations, however, made possible a qualitative leap in the macroeconomic environment compared with the two previous years. In 1997, countries were able to reap the fruits of their earlier efforts at domestic stabilization and rehabilitation of their banking systems. Progress was made possible not only by improved economic performance, but also by restored confidence on the part of national and foreign investors in the region's medium- and long-term prospects. Thus, in most countries, demand for money increased strongly and the local currency continued appreciating in real terms in foreign exchange markets. Renewed confidence and progress in reactivating the banking sector led to an expansion in bank lending and hence to increased investment. The effect was also observable in the public policy sphere, as the progress achieved in stabilization offered many countries the chance to ease up on some aspects of fiscal policy.

6. Turbulence in international financial markets following the crisis in South-East Asia dramatically changed the external environment and had obvious repercussions on the region's foreign exchange and financial markets.

7. The São Paulo stock exchange in Brazil – the region's largest by far, and the most active during the first half of the year – lost one third of its value, and the national authorities

depleted their reserves by 13 per cent defending the exchange rate from a fierce speculative onslaught. The Government responded first by doubling interest rates and then, on 10 November, with a 51-point emergency plan. The impact was not as great in the remaining Latin American economies, yet hampered external debt management and raised the cost of financing their current-account deficits. However, the good performance of the region's markets in comparison with what is happening in other emerging markets and the rapid response capacity of government economic teams has helped to reinforce the good opinion of investors about macroeconomic achievements in Latin America and the solidity of its prospects.

8. In any case, at the regional level, the shock was unable to reverse the cumulative gains in the financial markets up to the third quarter and had no effect on the tendency towards exchange-rate overvaluation, a trend that was on the increase during the first half.

A. Fiscal policy takes on a moderately pro-cyclical slant

9. Economic growth faster than expected in many countries of the region brought in greater tax revenues, particularly from domestic taxes and duties on consumer goods. In addition to this regionwide trend, a number of the countries that had been having problems with their public sector accounts the previous year adopted new measures to increase tax revenues, either by raising tax rates and tax bases (as in Colombia, Ecuador and Paraguay) or by postponing planned reductions in domestic or external taxes (as in Costa Rica and Barbados). Meanwhile, non-tax revenues tended to decline for reasons unrelated to fiscal policy. Such was the case in Chile in the second half of the year because of lower international prices for copper, and in Colombia and Peru because of a fall-off in capital revenues compared with the high levels recorded in 1996.

10. Expenditure generally increased more rapidly than revenue. Following several years of fiscal austerity, the countries of the region which found themselves in a somewhat easier fiscal situation resumed a policy of investment in new infrastructure projects and allocated more funds to social spending. This trend was most pronounced in Peru and Mexico. In some countries, increased spending was the result of mandatory increased transfers to pension and other social security systems as a result of social security reform (Argentina and Uruguay).

11. Owing to the combination of these revenue and expenditure trends, the fiscal deficit for the region as a whole increased slightly. The pattern noted is that the countries whose fiscal balance improved were those which had experienced fiscal problems the year before, with an average deficit of 2.5 per cent of GDP. In contrast, the fiscal situation tended to worsen in the countries whose public finances had previously been on a sounder footing, with an average deficit of barely half a per cent of output in 1996. In a few cases a wider deficit was the result of domestic emergencies; this was the case in Jamaica, which had to assume the cost of a serious banking crisis.

B. Foreign exchange policy responds to capital flows

12. During most of the year, foreign exchange policy was shaped by strong inflows of foreign capital that pushed nominal exchange rates downward, forcing monetary authorities to buy foreign currencies in order to stave off an even stronger real appreciation of the local currency and the consequent loss of competitiveness of the country's exports. The tendency towards currency appreciation was intensified in the first half, as the dollar strengthened in international markets and the cost of the regions' imports from Japan and Europe became relatively cheaper, a fact that helped to control domestic inflationary pressures.

13. Real currency appreciation moderated after the Asian crisis, which caused uneasiness in the region's main foreign exchange markets and led to fairly sizeable foreign exchange adjustments in some countries, among them Mexico and Chile. The region's currencies underwent an average real appreciation of 4 per cent. Colombia and Venezuela experienced the strongest appreciation (9.6 per cent and 20 per cent, respectively). Only three countries (El Salvador, Nicaragua and Trinidad and Tobago) saw significant real depreciation in 1997.

C. Monetary policy turns more expansive

14. The money supply grew strongly in 1997 as a result of monetization of incoming foreign capital, which continued to be abundant and resulted in an increase in net international reserves and an expansion in domestic credit, especially lending to the private sector. Despite sales of monetary stabilization bonds, the ratio of real local-currency liquidity to output rose by 5 per cent. The monetary expansion was in response to strong demand for local

currency, often observed when economies that have suffered recent bouts of high inflation remonetize. The most notable examples of expansion occurred in Brazil and Venezuela. By adjusting the money supply to greater demand for money, they avoided the destabilizing effects that usually accompany money creation on that scale. Hence, the expanded liquidity did not result in a deterioration in the external accounts, and monetary demand was accompanied by a slowdown in the rate of inflation.

15. Until the third quarter, nominal interest rates generally declined, for two main reasons. First, domestic financial markets finally responded to the slowing rate of inflation. Second, greater liquidity put downward pressure on interest rates. Since the decline in the inflation rate was even more rapid, the nominal drop was only partially reflected in real rates. It was significant that real lending rates were declining faster than deposit rates. In fact, between 1996 and 1997, real lending rates dropped on average from 16.6 per cent to 15.9 per cent, while real deposit rates rose from 2.6 per cent to 4.5 per cent. In most of the region, therefore, spreads were narrowing, although still high. Beginning in October 1997, international events forced some countries to raise domestic yields to stem an outflow of capital.

16. Greater liquidity in the banking system and the decline in the real cost of financing resulted in a significant increase in bank lending in a number of countries. Increased loan operations were also spurred by the measures adopted over the past three years to strengthen national financial markets by improving the regulatory framework and enabling stricken institutions to recapitalize. Easier access to bank financing was part of the reason for expanded investment in the region. Some countries, however, were still suffering the aftermath of prior (Paraguay) or recent (Jamaica) banking crises.

III. Domestic economic performance

A. Growth increases significantly

17. The rebound in activity levels in the Latin American and Caribbean countries in 1996 was accentuated in 1997. Average growth reached 5.3 per cent, nearly two points higher than the average for the 1990s and among the highest rates for the last 25 years. Per capita GDP increased by 3.6 per cent, marking an increase of 14 per cent since the start of the decade.

18. The improved regional economy is due especially to significant improvements in seven countries (Argentina, Costa Rica, El Salvador, Mexico, Peru, Uruguay and Venezuela) and continued strong growth in Chile and the Dominican Republic. Brazil, on the other hand, experienced only modest growth and because of the size of its economy kept the regional rate from showing even greater dynamism.

19. Growth in 1997 was experienced throughout the region, in confirmation of a trend already visible in 1996 and in contrast to the wide disparities observable in 1995. Not a single country experienced negative growth this year, and six (Argentina, Chile, Dominican Republic, Mexico, Peru and Uruguay) expanded activity by 6 per cent to 8 per cent. In seven economies the pace of growth was in the 4 per cent to 6 per cent range. In nine it was around 3 per cent. Only three countries (Haiti, Jamaica and Saint Lucia) experienced little or no growth.

20. The region's overall progress in 1996-1997 was stimulated by growth in investment, which far exceeded growth in GDP. The ratio of investment to GDP is expected to reach 24 per cent for the year, the highest rate in the 1990s. Investment growth was especially marked in Argentina, Bolivia, Costa Rica, Dominican Republic, Mexico, Nicaragua and Venezuela. To a large extent it was financed by external capital, since domestic saving increased more slowly than GDP.

21. Another major factor in the acceleration of activity was export growth, which was strong in a number of countries. However, domestic activity was undercut to some extent by the diversion of a good portion of domestic demand to imports, a trend made possible by trade liberalization in recent years and favoured by a significant drop in real exchange rates in most countries of the region.

22. Regional economic activity was affected in 1997 by the "El Niño" phenomenon, which caused serious drought in some areas and heavy rainfall in others, hurting agricultural output in particular and causing some damage to infrastructure. It also reduced catches of cold-water fish species. Meteorological predictions are that the phenomenon will not subside until well into 1998. In most of the Central American and some Caribbean countries, the warm ocean current caused severe drought; in South America, it was excessive rainfall that disturbed economic activities.

B. Inflation is at its lowest level in decades

23. Inflation rates continued to decline. In recent years, the average inflation rate for the region has dropped steadily, from 882 per cent in 1993 to 335 per cent in 1994, 26 per cent in 1995, 18 per cent in 1996 and 11 per cent in 1997,

its lowest level in 50 years. Moreover, 13 of the 22 countries considered achieved single-digit inflation. In most of the countries the rate of price increase slowed or remained low; only Barbados, Dominican Republic, Ecuador and Haiti showed an increased inflation rate, but in two of those countries it remained under 10 per cent. Although Venezuela succeeded in reducing its inflation rate sharply from 103 per cent to 38 per cent, it continues to have the highest inflation in the region. Moreover, the declining trend observable in Venezuela since the second half of 1996 reversed itself, so that in the fourth quarter inflation was at an annualized rate of around 50 per cent.

24. Among the countries with the best results were Argentina, which repeated its 1996 feat of virtually no inflation, and Brazil, which significantly slowed the pace of price increase to only 4 per cent in 1997, in contrast to its four-digit inflation in the late 1980s and early 1990s. Progress was also made in countries that had recently suffered a fresh outbreak of inflation. In Mexico, for example, after a sharp rise in 1995, inflation declined to 28 per cent in 1996 and again to 16 per cent in 1997.

25. The dramatic slowdown in inflation in the 1990s has been due chiefly to the shift in economic policy in recent years to making inflation-fighting a top priority and has been helped along by deep structural reforms and a relatively healthy world economy. Governments of the region gave unequivocal signals of their commitment to stabilization, and this had a positive effect on the expectations of economic agents.

C. Unemployment remains high

26. In 1997 urban unemployment in the region declined slightly, from 7.7 per cent to 7.4 per cent, but remained high in historic terms. Moreover, the slight drop was due not to strong job creation, but to reduced labour force participation. The chief exceptions to this rule were Mexico and Argentina, where a resumption of faster growth did help to generate jobs and reduce unemployment. In Brazil, Colombia and Uruguay, on the other hand, the employment rate declined.

27. In many countries of the region, economic restructuring has caused the disappearance of many jobs, which the fastest-growing sectors of the economy have not been able to replace with high-quality employment. Many of the new jobs created offer neither good benefits nor job security.

28. In contrast to earlier years, the spread between countries in trends in real wages in formal sectors has narrowed, an observation that accords with the region's recent tendency towards convergence in other respects. This reflects the region's successful emergence from the Mexican crisis and from bouts of high inflation and the end to the initially recessive impact of stabilization programmes. Thus, real wages either grew at moderate rates (as in Brazil, Chile and Colombia) or held steady (as in Argentina, Peru and Uruguay).

IV. External sector

A. Imports surge and the current account deficit widens

29. The current account deficit for Latin America and the Caribbean as a whole increased from US$ 36 billion in 1996 to US$ 60 billion in 1997 (3.2 per cent of GDP). The result was heavily influenced by large deficits in Brazil, Argentina and Mexico and Venezuela's smaller than usual surplus (excluding the latter, the deficit would come to US$ 65 billion). In nine countries, the ratio of the deficit to GDP was over 4 per cent, and in six of them, it exceeded 5 per cent.

30. In 1997 the region's foreign trade returned to the pattern typical of the earlier part of the decade, when imports grew faster than exports. As a result, the region's trade deficit widened from around US$ 8 billion in the two previous years to over US$ 28 billion in 1997. More than four fifths of the bulge reflected the ballooning deficits of Brazil and Argentina and the sharp contraction of Mexico's surplus. Most of the region's growing trade deficit was attributable to the shift in the merchandise trade balance to a deficit of some US$ 11.6 billion, after two years of surpluses (US$ 4.6 billion in 1996).

31. The 18 per cent growth in the value of imports was due entirely to the strong volume increase, since import prices were lower for almost all countries. The region benefited from the containment of inflation worldwide, which held the cost of manufactured products down; from the appreciation of the dollar, which made products purchased in other currencies cheaper; and from the decline in prices of some heavily imported commodities, such as petroleum and grains.

32. There were a number of reasons for the upswing in the volume of merchandise imports, which was large and occurred in all the countries. One reason was the accelerated growth of domestic demand in most countries, particularly investment. This trend was most striking in Argentina, Bolivia, Ecuador, Mexico, Nicaragua and Venezuela, which

all had large increases in import volumes. Another important factor was real appreciation of the currency in practically all the countries, especially Mexico and Venezuela. Other contributing factors were tariff reductions and loosening of import restrictions in the Central American countries and on some products in Brazil.

B. Export growth continues

33. Some of the increased import volumes were financed by a widespread improvement in the terms of trade (though not in Mexico or Venezuela), which together with expanded export volumes enhanced the purchasing power of exports. The terms of trade improvement resulted not only from cheaper import prices, already mentioned, but even more importantly from increases in average export prices for most of the countries, with the exception of Argentina, Bolivia, Mexico, Uruguay and Venezuela.

34. What lowered the average export price for this latter group were falling international prices of petroleum and grains – which lost much of the ground gained in 1996 – and beef hides – which were continuing a downward spiral. Other products of great importance to the region, however, underwent price increases, most notably coffee and bananas, which were chiefly responsible for better export prices in Central America, where the trend was most pronounced; prices of beef, shrimp, aluminum, zinc and to a lesser extent copper also went up.

35. What is most interesting is that despite the general real appreciation of currencies, all the countries (except Paraguay) succeeded in increasing their quantities of exports, so that volume (except in Honduras) was chiefly responsible for the growth in export earnings. For the region as a whole, the increase was more than 11 per cent, twice the rate of increase in output, and exceeded the predicted increase (7 per cent) in world trade volume for 1997.

36. This fact highlights the relative importance that factors other than exchange rates have assumed in determining the export performance of the region. Some of these reasons, apart from supply factors, are: the sustained growth of the world economy, estimated at between 3 per cent and 3.5 per cent in 1997; increased trade within subregional trading blocs, especially MERCOSUR, in which intra-bloc trade increased faster than total trade; and the development of the *maquila* industry in Central America, Mexico and the Caribbean (especially Haiti and the Dominican Republic), where some of the highest growth rates in export volumes were recorded. In addition to the serious deterioration of the trade balance, increased factor service payments were partly to blame for the current account deficit. Profit remittances increased significantly and equalled 6 per cent of the region's exports of goods and services. The current account deficit was readily financed despite its size, and the region increased its reserves by over US$ 13 billion. Much of that increase was attributable to the substantial reserve increases in Chile, Mexico, Peru and Venezuela.

C. Long-term capital flows grow stronger

37. In 1997 Latin America and the Caribbean continued to receive a heavy influx of foreign capital, amounting to somewhat more than US$ 73 billion, although the flow slackened somewhat in the last quarter because of the turbulence in financial markets provoked by the Asian crisis. A large proportion of the external financing was in the form of direct investment, bonds and medium-term bank loans. Short-term capital now represents only a moderate portion of capital flows in most Latin American countries and is chiefly used to finance foreign trade transactions (see figure 7).

38. Foreign direct investment (FDI) in 1997 amounted to some US$ 44 billion, an unprecedented figure. FDI hit all-time highs in Brazil, Dominican Republic, Mexico and Venezuela. In seven of the region's economies it equalled over 3 per cent of GDP. FDI was encouraged by the ongoing process of deregulation and liberalization of the rules governing foreign investment and by greater macroeconomic stability. Its sources became more geographically diverse. In consequence, foreign direct investment covered much of the balance-of-payments current account deficit for nine Latin American and Central American countries. In some countries, Brazil in particular, privatization was an important component of FDI; for the region as a whole, however, its contribution was more moderate: it accounted for only one fourth of the total.

39. In the first ten months of 1997 bond issues grossed some US$ 54 billion. Unlike foreign direct investment, financing through placement of debt instruments in international markets has been concentrated in just a few of the region's economies, notably Argentina, Brazil and Mexico. Most have been central government issues, with firms accounting for a lesser volume. Because of the turbulence caused by the Asian financial crisis, in the fourth quarter 1997 some Latin American Governments postponed new international bond issues to await a return to normality in international financial markets. The few issues placed during the period met with less favourable conditions.

40. Since 1995 there has been a steady increase in foreign bank loans. In the first half of 1997 they amounted to US$ 12 billion and contributed much of the financing (77 per cent) to private firms in the region. Most of the loans were granted by bank consortiums in the form of syndicated loans for terms of up to eight years, often three to five years, and spreads of 100 to 200 points above base rates. At the end of the year, this panorama was also negatively affected by the uncertainties created by the Asian turmoil.

41. Equity investment continued to account for a relatively small share of the short-term capital entering the region; it reached significant levels only in Argentina, Brazil, Chile and Mexico. Purchases of American depositary receipts (ADRs), representing equity in the region's firms, between January and September 1997 are estimated at US$ 4.2 billion, a figure that indicates a rebound, especially for Argentina and Brazil.

42. During the first half-year, prices rose spectacularly on most Latin American stock exchanges, especially Brazil's, where value doubled in dollar terms. The rise was due for the most part to positive expectations generated by the performance of the Latin American economies, but to some extent by speculative movements in some large international mutual funds. Due to the heavy financial turbulence in the Asian economies, most of the Latin American stock markets began to suffer sharp drops beginning in July, with some rebounds, and more decisively in October.

D. External debt grows moderately

43. In 1997 the region's total external debt expanded to US$ 645 billion, an increase of 2.5 per cent, which was less than the previous year's. Only Brazil, Chile and Colombia recorded significant increases in external liabilities, due largely to increased private sector borrowing, while Argentina's increase reflected expansion of public external debt. A number of Governments followed a prudent policy of improving the structure of the maturities on their public external debt, while continuing efforts to reduce the cost of financing. To achieve that, they turned to international bond markets to take advantage of the liquidity and better conditions that prevailed to September 1997. Some used part of the plentiful funds thus obtained to pay off short-term debt, while others used it to trade in Brady bonds. External debt burden indicators for 1997 reflected a general improvement; in fact, they were similar to those registered prior to the external debt crisis of the 1980s. For a few countries, however, particularly some in Central America, the indicators still reveal cause for concern.

44. Peru and Bolivia made progress in external debt negotiations. In March 1997 the Government of Peru signed an agreement restructuring some US$ 8 billion in external commercial debt, including late instalments and interest. In August 1997, the World Bank approved a debt relief programme for Bolivia under the terms of the heavily indebted poor countries initiative.

Latin America and the Caribbean: main economic indicators[a]

	1980	1990	1991	1992	1993	1994	1995	1996	1997[a]
Indices 1990 = 100									
Gross domestic product	90.9	100.0	103.6	106.8	111.1	117.3	117.5	121.8	128.2
Per capita gross domestic product	111.6	100.0	101.8	103.1	105.4	109.4	107.9	110.0	114.0
Annual rates of variation									
Gross domestic product	6.0	(0.3)	3.6	3.1	4.0	5.6	0.2	3.6	5.3
Per capita gross domestic product	3.6	(2.2)	1.8	1.3	2.2	3.8	(1.4)	2.0	3.6
Consumer prices	56.0	1 188.3	199.4	426.2	882.2	335.1	25.8	18.3	11.5
Terms of trade (goods f.o.b./f.o.b.)	10.1	1.4	(1.4)	0.5	(1.1)	4.2	3.4	0.7	2.0
Percentages									
Urban unemployment rate	6.2	5.9	5.8	6.2	6.2	6.3	7.2	7.7	7.4
Billions of dollars									
External sector									
Exports (goods)	91.6	136.3	137.1	146.4	160.8	186.9	226.8	252.7	281.9
Imports (goods)	92.5	105.2	123.9	151.2	168.8	200.5	224.9	248.1	293.5
Merchandise trade balance	(0.9)	31.1	13.2	(4.8)	(8.0)	(13.6)	1.9	4.6	(11.6)
Balance on current account	(30.1)	(2.0)	(17.2)	(34.1)	(44.2)	(48.5)	(32.3)	(35.6)	(59.9)
Balance on capital and financial account[b]	28.8	(7.9)	21.8	47.0	59.8	38.8	26.0	62.7	73.5
Balance-of-payments position	(1.3)	(9.9)	4.6	12.9	15.6	(9.7)	(6.3)	27.1	13.6
Total disbursed external debt	220.4	447.0	453.3	469.3	523.9	556.8	608.0	629.0	645.0

Source: ECLAC, on the basis of official figures.

[a] Preliminary.

[b] Includes errors and omissions.